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‘I hereby declare that I have read and understood the regulations governing the submission of the Master of Laws dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.’

**Cross – border partnerships and the issue of  
qualification conflicts: a German perspective.**

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## **A. Introduction:**

The ongoing process of economic globalization entails integration of national economies into the international economy and requires internationalization of national business structures. The progressing internationalization and globalization processes do however no longer only prompt the big concerns to operate on the world market. To an increasing extent smaller businesses also start to maintain international economic relations in order to resist the national and international competitive pressure and to represent marketability. Cross-border partnership structures are consequently increasingly common.

Their use in an international context however confronts consultants and clients with considerable taxing problems, due to the partnership's heterogeneous treatment by different countries for civil law and tax law purposes. The same partnership may be treated as taxable entity in one country, but as fiscally transparent in the other country, where tax liability is instead conferred to the partners of the partnership. In a cross-border partnership structure these two basic tax concepts may clash together resulting in a conflict of qualification between the countries involved. As the countries are of a different view of who constitutes the taxpayer, the application of tax treaties gives rise to serious problems and may even result in double taxation not adequately avoided.

Due to this potential tax conflict partnerships became a focus of discussion among German and international academics and subject to countless legal writings, resulting in various approaches and principles in this respect. The tax treatment of partnerships has however never been dealt with as thoroughly as by the OECD in its Partnership Report in 1999.<sup>1</sup> The Committee on Fiscal Affairs (CFA)<sup>2</sup> insofar discussed the issue by reference to different cross-border partnership situations and adopted different approaches to solve the respective conflicts of qualification based on the purpose of a tax treaty, namely to eliminate double taxation and to prevent double non-taxation in the two contracting states.<sup>3</sup> The results of this report have been subsequently

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<sup>1</sup> OECD *The Application of the OECD Model Tax Convention to Partnerships* Issues in International Taxation No 6 (1999).

<sup>2</sup> Hereinafter referred to as CFA.

<sup>3</sup> OECD (note 1) at para. 52.

incorporated in the Commentary to the OECD Model Tax Convention<sup>4</sup> (OECD MTC<sup>5</sup>).

This study deals with the issue of qualification conflicts regarding cross-border partnerships from a German perspective. German general and tax law treatment of partnerships as well as their classification for tax purposes is discussed in particular and serves as a point of departure throughout this study. The issues are studied in the context of tax treaties for the avoidance of double taxation.<sup>6</sup> It is insofar referred to the provisions of the OECD MTC.<sup>7</sup> In the first parts it is looked at the interpretation of tax treaties, the partnership's heterogeneous nature in civil and tax law, the different methods for the classification of entities for tax purposes and the actual origin of qualification conflicts in a cross-border situation. The main part deals with the taxation of cross-border partnerships based on two fixed examples, which aim at illustrating the different tax issues involved. The principles advocated by the OECD and other approaches developed in legal writings are applied to these examples and analyzed where appropriate. Finally the study deals with an alternative approach to qualification conflict. This approach may insofar be distinguished from the other approaches as it addresses the basic issue at another point.

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<sup>4</sup> OECD Model Convention on Income and Capital as of 2008. The OECD has elaborated and published a Model Tax Convention aiming at providing the countries with an instrument for the purpose of negotiating and designing their individual Double Tax Conventions with other countries. The OECD Model Tax Convention is a Model Treaty text consisting of 31 articles, each with a commentary. See Gerrit Frotscher *Internationales Steuerrecht* 2ed (2005) 22; Introduction to the OECD Model Tax Convention.

<sup>5</sup> Hereinafter referred to as OECD MTC.

<sup>6</sup> It is therefore not particularly dealt with the countries' domestic tax law. As regards the German domestic provisions concerning domestic partnerships and corporations see in this study chapter C s I, II, III, IV and concerning international taxation see in this study chapter D section I 1.. As regards the German unilateral rules for the elimination of double taxation see footnote 420. This shall however only provide for a general understanding. The specific issue of qualification conflicts is discussed without reference to domestic law.

<sup>7</sup> In fact, most of the existing Double Tax Conventions, even such negotiated between non-OECD members, refer to the basic structure and provisions of this Model.<sup>7</sup> It can be regarded as 'widely recognized source for the purpose of negotiating, designing and interpreting DTCs'. Specific DTCs between countries may vary in detail and their specific analysis would extend what is possible for the purpose of this study. See Para 3 of the introduction to the OECD MTC. Hereinafter, when discussing the provisions of a Double Tax Convention it is accordingly referred to the OECD MTC.

## **B. Interpretation of Double Tax Conventions**

### **I. General**

The main part of this study deals with issues regarding the application of Double Tax Conventions (DTC<sup>8</sup>) to the taxation of cross-border partnerships.<sup>9</sup> Therefore it is important to elaborate the interpretation of these agreements, since this area of law may even constitute the main reason for the issues dealt with in this study.

German domestic law does not provide for any written rules on tax treaty interpretation and as DTCs are agreements between states they cannot simply be interpreted by referring to domestic rules of interpretation which differ considerably from state to state.<sup>10</sup> By the same token, a DTC cannot be interpreted by different interpretation methods used in the two states respectively because otherwise it would fail its purpose, namely to bind both states equally.<sup>11</sup> An international approach to treaty interpretation is therefore required, i.e. interpretation, which lies right in the middle between various domestic methods acceptable by both contracting states.<sup>12</sup> It is nowadays accepted that DTCs are subject to an autonomous interpretation according to the rules of the Vienna Convention on the Law of Treaties<sup>13</sup> (VCLT<sup>14</sup>).<sup>15</sup>

For the purposes of this study it is Art 31-32 of the VCLT which are insofar of most relevance. It is indicated that the VCLT even applies between countries, which are not yet a party to the Convention, as its provisions reflect customary law for the interpretation of treaties.<sup>16</sup> The relevant articles of the VCLT and their prerequisites are discussed in the first part of this chapter. An exception to the autonomous

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<sup>8</sup> Hereinafter referred to as DTC.

<sup>9</sup> See in this study chapter D.

<sup>10</sup> Frotscher (note 4) 106.

<sup>11</sup> Klaus Vogel 'Transnationale Auslegung von Doppelbesteuerungsabkommen' (2003) 15 *Internationales Steuerrecht (IStR)* 523 at 553.

<sup>12</sup> Vogel (note 11) at 553.

<sup>13</sup> Vienna Convention on the Law of Treaties of 1969.

<sup>14</sup> Hereinafter referred to as VCLT.

<sup>15</sup> Michael Lang *Tax Treaty Interpretation* vol 3 (2001) 134; this is also confirmed by the wording of Art. 1 of the VCLT according to which the rules apply to treaties between states, which equally includes bilateral or even multilateral DTCs.

<sup>16</sup> Klaus Vogel *Doppelbesteuerungsabkommen* 5ed (2008) Einleitung des OECD-MA margin number 105.

interpretation constitutes art 3(2) of the OECD MTC which provides reference to the contracting states' domestic law regarding terms not defined in the treaty. This provision departs from the autonomous treaty interpretation under the VCLT and due to its reference to the countries' domestic law renders it more difficult for the contracting countries to arrive at a common interpretation.<sup>17</sup> Article 3 (2) may insofar constitute the main reason for qualification conflicts and their adverse effects and is therefore scrutinized in section III.<sup>18</sup>

As recommended by the OECD, the countries should base their individual DTCs on the OECD MTC and follow its Commentaries assisting the countries with the interpretation of the provisions of the Model Tax Treaty.<sup>19</sup> A considerable part of this study deals with the OECD Partnership Report of 1999, issued by the OECD CFA. This Report, which deals with the issue of qualification conflicts was eventually incorporated in the Commentaries to the OECD MTC. The weight of the commentary as instrument of tax treaty interpretation is therefore of considerable importance.<sup>20</sup> That the Commentary may be an important means of interpretation is insofar not subject to any dispute, although there is some uncertainty as to the legal basis for that assumption.<sup>21</sup> However, whether it may also affect treaties concluded prior to its amendment remains highly controversial.<sup>22</sup> The commentary and its role in the interpretation process are therefore subject to analysis in section IV.

## **II. Interpretation according to art 31 – 33 of the VCLT**

### **1. Article 31 - General rule of interpretation**

Article 31 of the VCLT as general rule of interpretation provides the following:

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<sup>17</sup> Vogel (note 16) Einleitung des OECD-MA margin number 112.

<sup>18</sup> Most treaties contain also other explicit references to the domestic law. For instance art 6 (2) of the OECD MTC. These references will however not be subject to any detailed analysis for a lack of relevance to this study.

<sup>19</sup> Para 3 of the introduction to the OECD MTC.

<sup>20</sup> Arne Schnitger 'Die Einbeziehung des OECD-Kommentars in der Rechtsprechung des BFH' (2002) 12 IStr 407 at 407; Vogel (note 16) Einleitung des OECD-MA margin number 125-127; Michael Lang (note 16) 134.

<sup>21</sup> Schnitger (note 20) at 407.

<sup>22</sup> Schnitger (note 20) at 407.

(1) A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

(2) The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

a. any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

b. any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by other parties as an instrument related to the treaty.

(3) There shall be taken into account, together with the context: subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation, any relevant rules of international law applicable in the relations between the parties.

(4) A special meaning shall be given to a term if it is established that parties so intended.

It used to be subject to dispute whether the wording or the purpose should prevail in interpreting tax treaties.<sup>23</sup> This, however, came to an end with the rules of the VCLT and in particular with the general rule of art 31 (1).<sup>24</sup> Despite its general wording, it is now commonly recognized that it gives priority to the treaty text (textual approach), since it stipulates that the interpretation must be based on the terms of the treaty.<sup>25</sup> This entails an objective approach rendering the terms of the treaty important and insofar ignoring the intention of the parties.<sup>26</sup> The intention is of relevance, however, insofar as it finds its expression in the text of the treaty.<sup>27</sup>

The interpretation is based on the “ordinary meaning” of the terms which nevertheless does not necessarily refer to the colloquial language.<sup>28</sup> As far as a specific meaning of a term has developed in a relevant area and received general acceptance, this meaning constitutes the ordinary meaning in terms of art 31 (1).<sup>29</sup> The ordinary meaning may thus comprise terms developed under the influence of the

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<sup>23</sup> Vogel (note 16) Einleitung des OECD-MA margin number 102 .

<sup>24</sup> Vogel (note 16) Einleitung des OECD-MA margin number 102.

<sup>25</sup> Vogel (note 16) Einleitung des OECD-MA margin number 106; Vogel (note 11) at 526.

<sup>26</sup> Frotscher (note 4) 107.

<sup>27</sup> Vogel (note 16) Einleitung des OECD-MA margin number 107; Jesper Barenfeld *Taxation of Cross-Border Partnerships* (2005) 31.

<sup>28</sup> Barenfeld (note 27) 27.

<sup>29</sup> Vogel (note 16) Einleitung des OECD-MA margin number 108.

OECD MTC and its commentary in the area of DTCs, occasionally referred to as the 'international tax language'.<sup>30</sup> The 'ordinary meaning' shall in this regard constitute a borderline between 'acceptable and unacceptable meanings' of a term, in order to avoid an interpretation which falls outside the 'normal or sensible meaning'.<sup>31</sup>

Apart from art 31 (1), it is provided in art 31 (4) that the parties may also attribute a special meaning to a term which may deviate from the ordinary meaning. The intention of the parties is then expressed in the text of the individual DTC and has therefore got to be considered as indicated above.

The ordinary meaning has to be established based on the context of the treaty terms (systematic interpretation<sup>32</sup>).<sup>33</sup> The context, as described in art 31 (2), includes text, preamble and annexes of a DTC, as well as additional agreements and other instruments or materials in connection with the conclusion of the tax treaty.<sup>34</sup> By considering the type of materials it is implied that they have to be agreed on by the contracting parties and results in the exclusion of documents not accepted by both parties<sup>35</sup>. According to the systematic interpretation of the ordinary meaning not only the application of the term in the specific section or subsection alone is of relevance, but also the application in the entire treaty and further documents which became part of the agreement. Not included in the context are 'subsequent agreements between the parties' or 'subsequent practices' which nevertheless expand the context as they need to be considered in connection with it.<sup>36</sup>

Finally the term shall be interpreted in the light of the object and purpose of the treaty (teleological interpretation<sup>37</sup>).<sup>38</sup> The treaty is thus to be interpreted in a way which enables it to achieve its purpose or object to the highest possible extent<sup>39</sup>. However, Vogel indicates that the purpose may not be considered an independent

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<sup>30</sup> Vogel (note 16) Einleitung des OECD-MA margin number 108.

<sup>31</sup> Barenfeld (note 27) 26.

<sup>32</sup> Frotscher (note 4) 107.

<sup>33</sup> Frotscher (note 4) 107; Barenfeld (note 27) 28.

<sup>34</sup> Barenfeld (note 27) 27.

<sup>35</sup> Barenfeld (note 27) 27.

<sup>36</sup> See art 31 (3) of the VCLT.

<sup>37</sup> Frotscher (note 4) 108.

<sup>38</sup> See Art 31 (1) of the VCLT.

<sup>39</sup> Frotscher (note 4) 108.

means of interpretation, as it is in turn based on the wording of the treaty text.<sup>40</sup> This in turn is implied by the words 'in the light of' the purpose.<sup>41</sup> The purpose and object is accordingly a 'guiding tool in the search for the ordinary meaning of a word as suggested in the contextual materials'<sup>42</sup> and hence a rather secondary means of interpretation.<sup>43</sup> Furthermore as already assumed above, purpose and object are to be regarded as a single expression, as there is no recognizable difference in the meaning of these terms.<sup>44</sup>

The object of the OECD MTC constitutes the avoidance of double taxation<sup>45, 46</sup>. Consequently the treaty shall be interpreted in a way which avoids double taxation whenever possible. Lang advocates that this approach must be subject to certain limitations and hence cannot operate as the underlying premise for each and every situation.<sup>47</sup> This approach may however be utilized as a supportive argument for the solution of qualification conflicts and their adverse effect, namely the unrelieved double taxation of cross-border partnerships.<sup>48</sup>

Whether the object of the OECD MTC also includes the avoidance of double non-taxation, remains subject to debate.<sup>49</sup>

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<sup>40</sup> Vogel (note 16) Einleitung des OECD-MA margin number 106.

<sup>41</sup> Vogel (note 16) Einleitung des OECD-MA margin number 106.

<sup>42</sup> Barenfeld (note 27) 28.

<sup>43</sup> Barenfeld (note 27) 28.

<sup>44</sup> Vogel (note 16) Einleitung des OECD-MA margin number 109.

<sup>45</sup> For the meaning of the term 'double taxation' see in this study chapter D section I 1..

<sup>46</sup> Para. 16 of the Introduction to the Commentary on the OECD MTC; OECD Partnership Report (note 1) para. 53; Michael Lang 'Die Vermeidung der Doppelbesteuerung und der doppelten Nichtbesteuerung als DBA-Auslegungsmaxime?' (2006) 18 *IStR* 609 at 613; Frotscher (note 16) 108.

<sup>47</sup> Michael Lang *The Application of the OECD Model Tax Convention to Partnerships* (2000) 29; Michael Lang (note 46) at 613.

<sup>48</sup> See in this study chapter D.

<sup>49</sup> OECD Partnership Report (note 1) para. 52; Ekkehart Reimer 'Seminar F: Die sog. Entscheidungsharmonie als Maßstab für die Auslegung von Doppelbesteuerungsabkommen' (2008) 15 *IStR* 551 at 551; Michael Lang (note 16) 131; Michael Lang (note 47) 29. Double non-taxation means that the income is neither taxed by the country of residence nor by the country of source. For instance, according to the tax treaty the source country regards itself as being precluded from taxing the income, however the same income is nevertheless exempted from tax by the country of residence according to the double tax relief rules of the tax treaty. For a lack of relevance to the purposes of this study this problem is not further dealt with. See Michael Lang (note 46).

## 2. Article 32 – supplementary means of interpretation

Article 32 of the VCLT provides that,

‘recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- a. leaves the meaning ambiguous or obscure; or
- b. leads to a result which is manifestly absurd or unreasonable.’

According to art 32 the supplementary means referred to either serve as a confirmation of the results gained from the application of art 31 or may be applied in order to come to a reasonable meaning of the term, if this was not possible by means of the interpretation under art 31. Explanations relating to a DTC, given by one state after the conclusion of the treaty during its domestic implementation process, are regularly not subject to art 32, as this material may not be considered work “of the treaty” and did not take part in its conclusion.<sup>50</sup> However, art 32 also allows recourse to other supplementary means apart from preparatory work of the treaty and the circumstances of its conclusion, as it explicitly states ‘including’ which cannot be considered as constituting a limitation to the means enumerated in it.<sup>51</sup>

## III. Article 3 (2) of the OECD MTC

Article 3 (2) provides the following:

‘As regards the application of the provisions of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which this Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.’

The practical advantages of this provision are obvious. As reference is provided for undefined terms the OECD MTC can be kept in a straightforward length without an

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<sup>50</sup> Vogel (note 16) Einleitung des OECD-MA margin number 110.

<sup>51</sup> Barenfeld (note 27) 30.



increasing number of definitions and remains therefore easier applicable.<sup>52</sup> Besides, domestic courts, authorities and the taxpayer can stick to the familiar domestic law meaning of tax treaty terms.<sup>53</sup>

Special interpretation rules, like particular definitions of the OECD MTC<sup>54</sup> or specific references to the terms domestic law understanding<sup>55</sup> prevail over the general provision of art 3 (2) and therewith limit its scope.<sup>56</sup>

Compared to general interpretation rules, art 3 (2) enjoys priority. Its application is, however, limited by its own wording.<sup>57</sup>

The provision only refers to the tax law definition, i.e. to the meaning that the term has 'for the purposes of the taxes'. Included are only the taxes covered by the OECD MTC.<sup>58</sup> The tax law definition shall insofar prevail provided the term has a different meaning in another branch of domestic law.<sup>59</sup> If the term has only a meaning in another branch of law, art 3 (2) does not apply at all.<sup>60</sup>

The dispute about, whether Art 3 (2) refers to the domestic law existing when the treaty was entered into ('static reference'), or to the law existing at the time of the tax treaty application ('dynamic reference') is in the meantime decided in favor of the latter alternative.<sup>61</sup> The dynamic reference is insofar of practical advantage as it does not require the Contracting States to renegotiate the tax treaty but enables them to apply the treaty despite any amendments to their domestic law.<sup>62</sup> It should, nevertheless, be subject to certain limitations and does not also cover 'radical' amendments to domestic law changing the tax treaty substantially.<sup>63</sup>

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<sup>52</sup> Guglielmo Maisto *Tax Treaties and domestic Law* vol 2 (2006) 124-125; Andrea Amatucci *International Tax Law* (2006) 160.

<sup>53</sup> Amatucci (note 52) 160.

<sup>54</sup> For instance art 11 (3) or art 12 (2) of the MTC.

<sup>55</sup> For instance art 6 (2) or art 10 (3) of the MTC.

<sup>56</sup> Vogel (note 16) OECD-MA Art 3 margin number 107.

<sup>57</sup> Vogel (note 16) OECD-MA Art 3 margin number 102.

<sup>58</sup> According to art 2 (1) of the OECD MTC the tax treaty deals with taxes on income and capital.

<sup>59</sup> Vogel (note 16) OECD-MA Art 3 margin number 103.

<sup>60</sup> Vogel (note 16) OECD-MA Art 3 margin number 103.

<sup>61</sup> Michael Lang (note 16) 147; Amatucci (note 52) 161.

<sup>62</sup> Amatucci (note 52) 161.

<sup>63</sup> Guglielmo (note 52) 133; Amatucci (note 52) 161.

The domestic law meaning shall only be relevant if the context does not require otherwise.<sup>64</sup> In this respect it is suggested that the context shall be interpreted very broadly.<sup>65</sup> The rather narrow designed context in terms of art 31 (2) of the VCLT is insofar not of significance for the OECD MTC.<sup>66</sup> Supportive in this respect is the origin of the term context from the British law defined as even encompassing the antecedents and the history of origin.<sup>67</sup> The context should therefore include the contractual documents, the MTC and its commentary, relevant provisions of the domestic systems of the two contracting states and as the case may be even provisions of other Conventions of the contracting states.<sup>68</sup> As far as the context provides compelling reasons in this broad sense, it may be departed from the interpretation according to the contracting states' domestic law.<sup>69</sup>

Besides its advantages indicated above, the provision may on the other hand result in situations where the contracting states apply a tax treaty differently (conflict of qualification<sup>70</sup>) by referring to their diverging domestic law, giving rise to double taxation or even double non-taxation of income.<sup>71</sup> In this respect, Lang tries to solve such conflicts in the context of cross-border partnerships by interpreting the clause 'unless the context otherwise requires' in a very broad way.<sup>72</sup> This clause shall emphasize that the treaty should primarily be interpreted autonomously from its context. Recourse to the domestic law of the Contracting States may accordingly only constitute a subsidiary means, applicable in cases where the autonomous interpretation does not lead to reasonable results. Others, however, object this approach.<sup>73</sup> They nevertheless attribute to the term 'context' a very broad meaning which in turn also increases the possibility of an autonomous interpretation and decreases the possibility of a conflict of qualification when referring to the domestic law of the respective States.

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<sup>64</sup> See Art 3 (2) of the OECD MTC.

<sup>65</sup> Vogel (note 16) OECD-MA Art 3 margin number 121.

<sup>66</sup> Vogel (note 16) OECD-MA Art 3 margin number 121.

<sup>67</sup> Vogel (note 16) OECD-MA Art 3 margin number 121.

<sup>68</sup> Amatucci (note 52) 161; Vogel (note 16) OECD-MA Art 3 margin number 121.

<sup>69</sup> See Art 3(2) of the OECD MTC.

<sup>70</sup> Vogel (note 11) 528; Amatucci (note 52) 161.

<sup>71</sup> Vogel (note 11) 528; Vogel/Lehner (note 16) OECD-MA Art 3 margin number 112; Reimer (note 49) 551; Michael Lang (note 16) 146.

<sup>72</sup> Michael Lang (note 47) 27-8.

<sup>73</sup> Vogel (note 16) OECD-MA Art 3 margin number 121.

The approach advocated by Lang is further dealt with in another part of this study.<sup>74</sup>

#### **IV. The role of the Commentary to the OECD MTC in the interpretation process**

##### **1. Legal basis for the consideration of the OECD Commentary**

The OECD commentary is meanwhile widely recognized as a very promising and important instrument for the interpretation of tax treaties.<sup>75</sup>

This recognition is, however, subject to some limitations.

The interpretation of Tax Treaties is governed by the VCLT and its textual approach.<sup>76</sup> The commentaries are therefore without any impact if a tax treaty text provides for a clear wording.<sup>77</sup> Besides, as the commentaries are based on the text of the OECD MTC they cannot influence the interpretation of a DTC containing a treaty text materially deviating from the provisions of the MTC.<sup>78</sup> Finally, it is indicated that the commentaries are of more significance for OECD member states, compared to non –members<sup>79</sup>, as the former actively contribute to the development of the OECD MTC and its commentaries.<sup>80</sup>

The legal significance of the commentary for the interpretation of DTCs is based on the provisions of the VCLT.<sup>81</sup>

Insofar the amended commentary version is clearly of significance for the interpretation of DTCs, concluded after its amendments became publicly known or officially published.<sup>82</sup>

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<sup>74</sup> See chapter D section II 1. b) aa) (1).

<sup>75</sup> Frotscher (note 4) 109; Schnitger (note 20) 408, Michael Lang (note 47) 20; Michael Lang 'Seminar B, Teil 2: Das OECD Musterabkommen – 2001 und darüber hinaus: Welche Bedeutung haben die nach Abschluss eines Doppelbesteuerungsabkommens erfolgten Änderungen des OECD Kommentars?' (2001) 17 *IStR* 536 at 536; Michael Lang (note 16) 134; Barenfeld (note 27) 37; para 15, 29 of the introduction to the Commentary on the OECD MTC.

<sup>76</sup> See in this study chapter B section I.

<sup>77</sup> Barenfeld (note 27) 38.

<sup>78</sup> Michael Lang (note 16) 136.

<sup>79</sup> South Africa, for instance, is not a member of the OECD. See OECD MTC.

<sup>80</sup> Vogel (note 16) Einleitung des OECD-MA margin number 133; Barenfeld (note 27) 39.

<sup>81</sup> Vogel (note 16) Einleitung des OECD-MA margin number 123.

Following the prevailing opinion in legal writings the commentary constitutes the expressed special meaning according to art 31 (4).<sup>83</sup> As long as the contracting parties conclude tax conventions based on the wording of the OECD MTC, they attribute to the provisions a meaning following from the OECD MTC and its commentary.<sup>84</sup> In this respect, the commentary represents the common intent of the parties to give a special meaning to an expression.<sup>85</sup> Indeed, the highly professional and technical area of international tax law requires that terms are given special meanings.<sup>86</sup> It calls for the definition of provisions by detailed and extensive commentaries, which in turn indicates that the provisions in a tax treaty are intended to have a special meaning referred to in the commentary.<sup>87</sup> For these reasons art 31 (4) seems to be the most reasonable legal basis for the consultation of the commentary in the interpretation process. The commentary is therefore to be regarded as the special meaning given to expressions of the OECD MTC.

## **2. Relevance of the modifications of the OECD Commentary for previously concluded DTCs**

Another question is, whether the amended version of the commentary has any relevance for the purpose of interpreting tax treaties concluded prior to its amendments.

According to the CFA amendments to the OECD MTC and changes to the commentary are without impact on the interpretation of previously concluded Conventions where there is a difference in substance between the provisions of those Conventions and the amended articles (static approach), but that other changes or additions to the commentary are nevertheless relevant also for the interpretation of

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<sup>82</sup> Michael Lang (note 47) 20; Michael Lang (note 76 ) at 536; Schnitger (note 20) at 407; Barenfeld (note 27) 37.

<sup>83</sup> Barenfeld (note 27) 41; Vogel (note 11) at 527; Michael Lang (note 16) 135; Schnitger (note 20) at 407. However, according to other scholars the Commentary may also constitute the ordinary wording in terms of art 31 (1) VCLT. See Vogel (note 16) Einleitung des OECD-MA margin number 126.

<sup>84</sup> Vogel Einleitung des OECD-MA margin number 126.

<sup>85</sup> Barenfeld (note 27) 41.

<sup>86</sup> Barenfeld (note 27) 41.

<sup>87</sup> Barenfeld (note 27) 42.

Conventions concluded prior to those changes or additions (‘ambulatory approach’).<sup>88</sup>

The OECD therefore advocates an ambulatory approach as long as changes or additions only aim at clarifying already existing provisions.<sup>89</sup>

The reason why the OECD advocates such an approach is due to practical advantages attached to it.

Since 1992 the OECD MTC and its commentary is published in a loose-leaf system and the commentary in particular was subject to many amendments over the years.<sup>90</sup>

The preference for amending the commentary instead of the OECD MTC itself is due to the idea, that a modified OECD MTC would not necessarily influence the bilateral treaty praxis.<sup>91</sup> This would require those changes to be reflected in the individual bilateral tax treaties which can take many years of negotiations. On the other hand, a modified commentary could at least according to the OECD, directly influence even previously concluded bilateral DTCs without any time consuming adoption processes.<sup>92</sup>

However, as the OECD does not give any reasons for its approach and is also not a lawmaking body<sup>93</sup>, its approach has to be analyzed critically on the basis of the VCLT where the legal authority of the commentary can actually be drawn from.<sup>94</sup>

A later version of a commentary cannot be considered part of the context in terms of art 31 (2), as its changes and amendments are not made ‘in connection with the conclusion’ of a previously concluded treaty.<sup>95</sup> Furthermore, only the commentary existing upon conclusion of the individual DTC may in fact influence the parties’ intention as for the meaning of the words.<sup>96</sup> For this reason a later version cannot be considered as ordinary meaning in terms of art 31 (1) or special meaning according

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<sup>88</sup> Para. 35 of the Introduction on the OECD MTC.

<sup>89</sup> Barenfeld (note 27) 45.

<sup>90</sup> Foreword on page 3 of the OECD MTC.

<sup>91</sup> Michael Lang (note 76) at 536.

<sup>92</sup> Michael Lang (note 76) 536.

<sup>93</sup> Michael Lang (note 47) 15.

<sup>94</sup> Seen in this study chapter B section IV. 1..

<sup>95</sup> Michael Lang (note 47) 16.

<sup>96</sup> Vogel (note 16) Einleitung des OECD-MA margin number 127.

to art 31 (4).<sup>97</sup> By the same token art 32 cannot serve as a basis for considering the new version of the commentary, as it refers to material indicating the intention of the parties upon conclusion of a treaty.<sup>98</sup>

The ambulatory approach can also not be pursued over art 31 (3) as the amendment decision taken by the OECD CFA does not qualify as an 'agreement' since the OECD MTC and its commentary is drafted by an international organization and not by the contracting parties to the tax convention.<sup>99</sup> Neither does subsequent practice apply, because it does not cover or justify changes of already existing treaty provisions.<sup>100</sup>

Apart from the provisions of the VCLT which do not provide support for the consideration of a later version of the commentary for the interpretation of previously concluded tax treaties, one could argue that the parties to a tax treaty usually accept the interpretation according to the commentary despite any future changes at the moment of conclusion.<sup>101</sup>

However, there are other reasons which render such an approach unreasonable.

By assuming, that it is the interpreter's task to investigate the intention of the parties as legislators of the respective DTC, one underlines the irrelevance of the later version of the commentary, since the parties simply could not agree with a meaning of a provision they did not know at the time of the conclusion of the treaty.<sup>102</sup>

Furthermore, the ambulatory approach does not comply with many countries' constitutional law as the principle of separation of powers prohibits the tax authorities to act as a legislator.<sup>103</sup> In Germany, for instance, art. 59 (2) of the Constitution requires parliamentary consent in case of a substantive change of an international contract. There is thus basically no way that such a consensus could be substituted by a decision of the OECD CFA, unless the amendment constitutes a

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<sup>97</sup> Vogel (note 16) Einleitung des OECD-MA margin number 127.

<sup>98</sup> Vogel (note 16) Einleitung des OECD-MA margin number 127.

<sup>99</sup> Michael Lang (note 47) 17.

<sup>100</sup> Michael Lang (note 47) 18.

<sup>101</sup> Barenfeld (note 27) 46.

<sup>102</sup> Michael Lang (note 76) at 536.

<sup>103</sup> Articles 1 Abs. 3, 20 Abs. 2, 20 Abs. 3 and 20a of the German Constitution.

mere clarification of an existing legal provision.<sup>104</sup> As the notion of clarification is sometimes utilized by the authorities to justify the ambulatory approach and apply provisions to the disadvantage of the individual taxpayer<sup>105</sup> and as it can be very difficult to differentiate clearly between a mere clarification and a substantive change, it has to be approached with the utmost caution.<sup>106</sup> Besides, it is in fact absurd to consult a new version of the commentary when the content did not change compare to the old version but merely clarified the previous provision, as these provisions already allowed for the newly incorporated interpretation and hence make the consultation of the later version redundant.<sup>107</sup>

The rule that changes or amendments should influence the interpretation of previously concluded tax treaties has been explicitly incorporated in the recent treaty between Germany and Austria.<sup>108</sup> However, also in this regard it remains uncertain how this rule can be binding considering the indicated constitutional concerns.<sup>109</sup>

In conclusion, a “retroactive effect”<sup>110</sup> of the OECD commentary cannot be based on any provision of the VCLT and it does, even if nevertheless applied, not comply with the requirements of the constitution.

In this respect the newly incorporated Partnership Report is to be regarded as a substantive change of the commentary and therefore not to be considered for previously concluded treaties.<sup>111</sup>

It could only insofar influence earlier tax treaties as its reasoning is convincing.<sup>112</sup>

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<sup>104</sup> Michael Lang (note 16) 137.

<sup>105</sup> Vogel (note 16) Einleitung des OECD-MA margin number 129; Michael Lang ‘DBA und Personengesellschaften – Grundfragen der Abkommensauslegung’ (2007) 17 *ISIR* 606 at 606-7.

<sup>106</sup> Vogel (note 16) Einleitung des OECD-MA margin number 129.

<sup>107</sup> Michael Lang (note 105) at 607.

<sup>108</sup> Double Tax Convention of 24 August 2000, No 16 of the Final Protocol, quoted in Vogel (note 16) Einleitung OECD-MA margin number 127.

<sup>109</sup> Vogel (note 16) Einleitung OECD-MA margin number 129.

<sup>110</sup> Michael Lang (note 16) 137.

<sup>111</sup> Schnitger (note 20) at 408. This applies to all tax treaties concluded prior to april 2000. See Hans Weggenmann ‘Die Empfehlungen der OECD an den Ansässigkeitsstaat zur Lösung von Einordnungskonflikten in Bezug auf Sondervergütungen’ (2002) 18 *ISIR* 614 at 623.

<sup>112</sup> Michael Lang (note 47) 20. However according to Lang the incorporated Partnership Report is to a great extent lacking such reasoning and therefore only of little value for the interpretation of previously concluded tax treaties.

### 3. Consideration of the OECD commentary in German case law

In general, the OECD MTC and its commentaries have been frequently utilized for the interpretation of bilateral treaty provisions by German tax courts.<sup>113</sup> This underlines the general recognition of the commentary as significant tool for the interpretation process.

Whether the German jurisdiction pursues a static or ambulatory approach with respect to the commentary is a more difficult question. There are particularly four significant cases in this respect.

In a 1990 decision the BFH<sup>114</sup> had to deal with the DTC between Germany and Belgium and particularly with the concept of an artist for tax treaty purposes. For this purpose the BFH consulted the OECD MTC and its commentary on basis of the VCLT without mentioning the specific provision. However, the BFH used not the updated version of the commentary, but the commentary valid at the time of conclusion of the DTC. Despite the fact, that the BFH did not reason why it was reluctant to consult the later version of the commentary and failed to mention the constitutional relevance of such a consultation, the decision indicates that the BFH pursued the static approach regarding the Commentary to the OECD MTC.

The decision of 1997<sup>115</sup> was also concerned with the concept of an artist in terms of the German DTC with the UK. In this judgment the BFH, however, referred to the 1977 version of the commentary in order to interpret a provision of the tax treaty between Germany and the UK concluded prior to the amended version of the commentary. Nevertheless, it cannot be determined whether the BFH clearly pursued the ambulatory approach in this respect, as it used the commentary only as additional source in order to support its view and also failed to mention any reasoning for the consultation of the later version of the commentary.

In a 2000 judgment the BFH seemed to rather pursue a static approach.<sup>116</sup> The court dealt with the income classification of an Austrian professional sportsman who

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<sup>113</sup> Michael Lang (note 16)

<sup>114</sup> BFH 11.04.1990, IR 75/88, BFHE 160, 513. Quoted and discussed in Schnitger (note 20) at 408.

<sup>115</sup> BFH 08.04.1997, IR 51/96, BStBl II 1997. Quoted and discussed in Schnitger (note 20) at 409.

<sup>116</sup> BFH 11.10.2000, IR 44-51/99, IStR 2001, 182 m. Anm. KB. Quoted and discussed in Schnitger (note 20) 409.



attended German sport events. Without clearly stating its attitude towards the ambulatory approach with respect to the commentary, the court specifically found that the version of German domestic law valid at the moment of the conclusion of the treaty is considered of significance when interpreting a tax treaty according to domestic law.

However, the decision of 2001 appears to show a change of the BFH jurisdiction in this respect.<sup>117</sup> The concept of an artist and the DTC between Germany and Austria and Germany and the Netherlands were subject to the judgment. The BFH supported its decision by expressly referring to a later version of the commentary of 1977. However, once again it did not reason its reference and failed to discuss the constitutional issues of such reference.

To sum up, at least recently the BFH does not seem to clearly object an ambulatory approach. However, it should more expressly mention the approach it pursues and deal with the possible constitutional issues involved. Otherwise the rather inconsistent jurisdiction and the lack of clear reasoning in past decisions results in legal unpredictability from the perspective of the taxpayer and the tax authorities in this respect.

## **C. Partnerships and their qualification for tax purposes**

### **I. General:**

As this study deals with partnerships and their tax treatment in cross-border situations it is object of the following chapter to illuminate different features of partnerships and their different qualification for tax purposes. The point of departure in this respect constitutes the German partnership understanding as the study especially focuses on the German perspective regarding the taxation of cross-border partnerships.

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<sup>117</sup> BFH 18.07.2001, I R 26/01, IStR 2001, 653. Quoted and discussed in Schnitger (note 20) 410.

The different German partnership forms are subject to examination under section II. The section does not discuss the subject in depth, but rather focuses on the main features that are essential to distinguish partnerships from other contractual relationships and corporations. In fact, there is no common internationally recognized definition for partnerships.<sup>118</sup> However, one can extract the main characteristics from the German understanding of its domestic partnerships, to narrow down the concept of partnerships, as it should also be understood in a more general international context.

As indicated partnership`s civil law and tax law treatment varies considerably between countries` jurisdictions. Insofar the countries` domestic tax law approach regarding partnerships is of particular relevance for this study, as it constitutes a trigger for qualification conflicts concerning cross border partnerships and therewith a cause for the many issues involved.<sup>119</sup> The partnership`s legal and tax law status in Germany and internationally is therefore dealt with in section III.

After narrowing down the concept of partnerships, the basic concept of their taxation in comparison to corporations are subject to analysis in section III. In this respect, specific reference is given to the German legislation.

As there is a main difference with regard to their respective taxation, the countries` classification of entities as partnerships or corporations is focused on in section IV.

If the countries in a cross-border situation classify or treat the same entity differently for tax purposes the concepts of taxation regarding partnerships and corporations may clash together and provide for various tax issues.<sup>120</sup> The origin of such conflicts of qualification is dealt with in section V.

## **II. The general law concept of partnerships**

In order to distinguish the partnership from other contractual relationships and particularly from corporations, it is essential to define the main characteristics a partnership features.

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<sup>118</sup> Barenfeld (note 27) 55.

<sup>119</sup> See in this study discussion regarding art 3 (2) of the OECD MTC in chapter B section 3.

<sup>120</sup> See in this study chapter D.

In Germany the civil law partnership<sup>121</sup>, the general partnership<sup>122</sup> and the limited partnership<sup>123</sup> constitute the main legal partnership forms.<sup>124</sup> Their basic characteristics are dealt with in the following as far as they are of relevance from distinguishing the partnership from other legal phenomena and from corporations in particular.

The German definition of a civil law partnership sets up the legal basis for the other German partnerships<sup>125</sup> and shall therefore serve as a point of departure. Article 707 of the Civil Code<sup>126</sup> provides as follows:

‘Through the partnership contract, the partners commit themselves mutually to promote a common objective in a commonly agreed upon way, especially to contribute the agreed upon resources’.

By considering this basic definition there are a few main features which have to be taken into account when describing a partnership in Germany. A partnership involves a contractual relationship between persons aiming at pursuing a joint aim, ie the sharing of benefits<sup>127</sup> arising from the joint contribution of resources.

These features can be used to distinguish the partnership from other contractual relationship, such as loan agreements, lease contracts and licenses, where opposite parties are involved and where a joint aim and joint contribution of resources is missing.<sup>128</sup> As it also requires the cooperation between persons for the purpose of reaching a joint goal, the sole proprietorship must also be excluded from the meaning of a partnership.<sup>129</sup>

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<sup>121</sup> In Germany referred to as ‘Gesellschaft Bürgerlichen Rechts’.

<sup>122</sup> In Germany referred to as ‘Offene Handelsgesellschaft’.

<sup>123</sup> Referred to as ‘Kommanditgesellschaft’ in Germany.

<sup>124</sup> The German silent partnership (‘stille Gesellschaft’) constitutes a specific form of the civil law partnership. It deviates, however, considerably from the three main partnership forms and its specific features are not of relevance to the purpose of this study. Therefore it not subject to further examination. For an overview in this respect see Barenfeld (note 27) 78-80.

<sup>125</sup> Such as the general partnership and the limited partnership. According to section 105 (3) Commercial Code the provisions regarding the civil law partnership in the Civil Law Code are also applicable to the general partnership and the limited partnership, unless there are overriding specific provisions in the Commercial Code addressing the particular features of the general and limited partnership.

<sup>126</sup> Referred to as ‘Bürgerliches Gesetzbuch’ in Germany.

<sup>127</sup> A.H.M. Daniels *Issues in International Partnership Taxation* (1991) 3.

<sup>128</sup> Barenfeld (note 27) 63.

<sup>129</sup> Barenfeld (note 27) 63-4.

These basic characteristics are also shared by the German general and limited partnership. The basic structure of the civil law partnership is however expanded and modified by the Commercial Code<sup>130</sup> for these more complex partnership types.

The general partnership is insofar defined as:

‘A civil law partnership of which the purpose is to conduct a trade or business under a common firm...’<sup>131</sup>

In contrast to the civil law partnership the general partnership accordingly aims at carrying on a business or trade.<sup>132</sup>

The main characteristic of a limited partnership is that at least one or several but not all partners are subject to limited liability.<sup>133</sup> This distinguishes the limited from the general partnership<sup>134</sup> where all partners are jointly liable to the partnership’s creditors.<sup>135</sup>

One can therefore generally conclude that a partnership has at least one partner who is subject to unlimited personal liability which in turn distinguishes the partnership from a corporation where the liability of the members is completely replaced by the liability of the entity itself.<sup>136</sup> The creditors are in this respect confined to the corporation’s assets, ie its share capital.<sup>137</sup>

The composition of the partners in the partnership and their personal economic status are therefore of influence to the level of security of third parties.<sup>138</sup> A change of members in a corporation on the other hand is of no impact for its share capital and

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<sup>130</sup> Art 161 (1) of the German Commercial Code. Referred to as ‘Handelsgesetzbuch’ in Germany.

<sup>131</sup> Section 105 (1) Commercial Code.

<sup>132</sup> Daniels (note 127) 4.

<sup>133</sup> Section 161 (1) Commercial Code. The liability is insofar limited to their capital contribution.

<sup>134</sup> The provisions for the general partnership are according to section 161 (2) Commercial Code basically also applicable to the limited partnership. However the limited partnership constitutes a specific form of the general partnership.

<sup>135</sup> Section 105 (1) Commercial Code.

<sup>136</sup> Section 13 (2) Limited Liability Companies Act (in Germany referred to as ‘Gesetz für die Gesellschaft mit beschränkter Haftung’) regarding a limited liability company (in Germany referred to as ‘Gesellschaft mit beschränkter Haftung’) and section 1 (1) Public Limited Companies Act (in Germany referred to as ‘Gesetz für die Aktiengesellschaft’) regarding a company limited by shares (Aktiengesellschaft). One may also find the designations ‘partner-oriented’ and ‘capital oriented’ entity with respect to partnerships and corporations respectively. These terms refer to the source serving as security and basis for the liability. See Barenfeld (note 27) 60.

<sup>137</sup> Rijkele Betten ‘The international guide to partnerships’ (2005) IBFD Germany-Partnerships 1.1.. Available at <http://ip-online2.ibfd.org/igp/06/09/2005> [accessed 4 December 2009].

<sup>138</sup> Barenfeld (note 27) 61.

hence does not influence the level of liability of the company.<sup>139</sup> For these reasons the ownership in a corporation is freely transferable however subject to limitation with regard to partnerships.<sup>140</sup>

Finally, partnerships are characterized by personal connectivity<sup>141</sup> which is expressed in many provisions in the German legislation. According to s 119 of the Commercial Code the decision making process of a partnership requires unanimity among its partners. Furthermore s 709 of the Civil Code and s 114 of the Commercial Code generally provide for joint agency by all partners, unless one partner is designated as agent in the partnership agreement.<sup>142</sup> The partners are basically allowed to represent the partnership to the outside world.<sup>143</sup> A further indication for the personal connectivity within a partnership is the fact that it may either by law or by agreement be terminated upon death or withdrawal of a partner.<sup>144</sup>

A corporation in contrast is characterized by its indefinite and independent existence.<sup>145</sup> It can accordingly be represented by non-members.<sup>146</sup>

These distinctions become however less clear regarding a compound entity, consisting of a limited liability company being the sole general partner of a limited partnership and limited partners of the limited partnership being typically also the members of the limited liability company.<sup>147</sup> Such a compound entity contains elements of both a corporation and a partnership but is nevertheless regarded as partnership according to German law.<sup>148</sup>

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<sup>139</sup> Barenfeld (note 27) 61.

<sup>140</sup> Section 15 (1) Limited Liability Companies Act; Barenfeld (note 27) 61.

<sup>141</sup> Daniels (note 127) 4.

<sup>142</sup> Section 114 (2) Commercial Code.

<sup>143</sup> Section 714 Civil Law Code; s 125 Commercial Code.

<sup>144</sup> Section 723, 727 (1) Commercial Code.

<sup>145</sup> As indicated in section 13 (1) Limited Liability Companies Act; Rijkele (note 137) Germany-Partnerships 1.2.3..

<sup>146</sup> Section 26 (1) Civil Law Code; section 35 (1) Limited Liability Company Act; section 76 (1) Public Limited Companies Act.

<sup>147</sup> In Germany referred to as 'GmbH & Co KG'.

<sup>148</sup> Wolfgang Jakob *Einkommensteuer* 3ed (2003) 328. Considered a limited partnership with the GmbH as its only unlimited partner. Insofar the provisions dealing with limited partnerships apply. For its tax treatment see s 15 (3) of the German Income Tax Act. That it constitutes a recognized partnership form, is also indicated by section 19 (2) and 125a (1) of the German Commercial Code.

By ignoring the specific German legislation and particularities in this respect, the above characteristics of German partnership types could also provide for a more general concept of partnerships utilizable as definition in an international context.<sup>149</sup>

### III. General law and tax law status of partnerships

The above definition does, however, not say anything about a partnership's legal status and whether it can be regarded as a person liable to tax as such. These features are of specific interest for the purpose of this study and dealt with in the following.

#### 1. General law status

Legal capacity means the ability to be a subject of legal rights and duties.<sup>150</sup> Natural Persons take over such a capacity by birth<sup>151</sup> and juridical persons like corporations<sup>152</sup> regularly as from their official recognition.<sup>153</sup>

In some countries partnerships are treated like corporations for general law purposes.<sup>154</sup> Insofar they are regarded as separate legal entity with legal capacity.

According to German civil law, however, partnerships are not regarded as juridical persons.<sup>155</sup>

Whether partnerships can have the capacity to be a subject of legal rights and duties despite their lack of legal personality is subject to debate in Germany.

Some scholars still argue that only the partners are able to be subject of legal rights and duties and not the partnership as such<sup>156</sup>.

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<sup>149</sup> Barenfeld (note 27) 55-66 and particularly 66; see also Daniels (127) 3-4.

<sup>150</sup> Barenfeld (note 27) 69.

<sup>151</sup> Section 1 of the Civil Law Code.

<sup>152</sup> A Corporation is considered a legal person according to s 1 (1) Public Limited Companies Act and s 13 (1) Limited Liability Companies Act. As consequence of its conferred legal personality it has accordingly legal capacity distinct from its members.

<sup>153</sup> For instance by their entry in the company registry. See insofar s 41 (1) Public Limited Companies Act and s 11 (1) Limited Liability Companies Act.

<sup>154</sup> Emil Brincker et al *International tax: a South African perspective* (2003) 558. This applies for instance to partnerships in Denmark.

<sup>155</sup> Karsten Schmidt 'Die BGB Außengesellschaft: rechts- und parteifähig- Besprechung des Grundlagenurteils II ZR 331/00 vom 29.1.2001' (2001) 14 *Neue Juristische Wochenschrift (NJW)* 993 at 996.

However most scholars in Germany meanwhile recognize the partnership as form of independent legal organization which may participate in legal relations and be subject of legal rights and duties, distinct from its partners.<sup>157</sup> According to this prevailing 'collective entity' approach the partnership is however to be regarded as only partly capable of holding rights. Although it may act independently in external legal relations, it is still not completely independent regarding its internal relations to its partners.

The German Civil Law Code seems to confirm this latter approach by expressly recognizing the legal capacity of partnerships.<sup>158</sup> This can also be supported by the wording of s 733 (1) 1 Civil Law Code which says 'joint debts' instead of the partner's individual liabilities. By the same token s 718 (1) Civil Law Code says 'joint capital of the partners'.

Furthermore, s 124 (1) Commercial Code expressly provides that a German general partnership<sup>159</sup> may acquire legal rights and accept obligations. It may also acquire ownership and be a party to court proceedings.

A partnership may therefore in Germany be considered as having partial legal capacity distinct from its partners.

## 2. Tax law status

As seen above, a partnership's treatment for civil law purposes may vary from country to country. In German civil and commercial law a partnership is more or less considered a person with legal capacity.

For German income tax purposes the partnership is however rather ignored according to the transparency principle<sup>160, 161</sup>.

<sup>156</sup> Jakob (148) 321. Referred to as 'Traditional approach'.

<sup>157</sup> Jakob (148) 321.

<sup>158</sup> See s 14 (2) of the Civil Law Code.

<sup>159</sup> This applies according to s 161 (2) Commercial Code also to the German limited partnership.

<sup>160</sup> Frotscher (note 4) 170; Rijkele (note 137) Germany-Partnerships 5.3.1.; Vogel (note 16) OECD-MA Art 1 margin number 17. In Germany referred to as 'Mitunternehmerkonzept'.

<sup>161</sup> Frotscher (note 4) 170.

Partnerships are not regarded as taxpayers but as fiscally transparent acting as a conduit for tax purposes.<sup>162</sup> Accordingly, the partnership's profits and losses flow through to the partners, considered to be the only taxpayers subject to individual income tax or corporate tax<sup>163</sup> regardless of any distribution or withdrawal.<sup>164</sup>

Within this concept, according to which the income is only subject to tax in the hands of the partners, there are two different approaches to be distinguished.

Some countries<sup>165</sup>, such as Germany, still treat a partnership as an independent entity in some ways.<sup>166</sup> According to that approach, partnerships are utilized as accounting entity, ie the income is computed and reported at the partnership's level<sup>167</sup> where the corresponding accounting elections are applied.<sup>168</sup> In this very respect the partnership is treated 'as if it were a taxpayer'.<sup>169</sup><sup>170</sup> The ascertained total profits of the partnership, however, are then to be allotted to the partners according to their respective share of these profits and are eventually taxed only at their level.<sup>171</sup> Procedurally, this is carried out through s 180 (1) No 2 (a) of the Internal Fiscal Code<sup>172</sup> which ultimately results in a binding assessment of the partners' shares of the partnership's profit (s 182 (1) of the Fiscal Code).<sup>173</sup>

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<sup>162</sup> Jakob (note 148) 320; Frotscher (note 4) 170. This however only applies to income tax. For business tax and VAT purposes the partnership is considered a taxpayer in Germany. As this study focuses only on income tax issues, these tax types are not subject to further discussion.

<sup>163</sup> Section 1 (1) and s 2 of the Income Tax Act applies in case of a natural person as partner. Section 1 (1) and s 8 (1) of the Corporate Tax Act (referred to as 'Körperschaftsteuergesetz' in Germany) applies if the partner constitutes a corporation.

<sup>164</sup> Jacobs *Internationale Unternehmensbesteuerung* 6ed (2007) part 4 chapter 4 A. II.

<sup>165</sup> The USA for instance. See Daniels (127) 24.

<sup>166</sup> Frotscher (note 4) 170; Jakob (note 148) 336-337; Barenfeld (note 27) 73-4. Referred to as 'entity approach'. Also applied by Canada, Finland and the USA. See Olivier 558-9 and Daniels (note 127) 24.

<sup>167</sup> Jakob (note 148) 336-337.

<sup>168</sup> Daniels (note 127) 27.

<sup>169</sup> Rijkele (note 137) Germany-Partnerships 5.3.1..

<sup>170</sup> Prior to 1975 the 'Bilanzbündel' theory applied, according to which the partnership was completely ignored. Subject to tax was only the individual partner, which was treated as a sole proprietor. The partnership was regarded as a 'bundle' of all partners' accounts. This approach was eventually abandoned and replaced by the entity approach, described above. See Jakob (note 148) 336.

<sup>171</sup> Jacobs (note 164) part 4 chapter 4 A. I. .

<sup>172</sup> In Germany referred to as 'Abgabenordnung'.

<sup>173</sup> Jakob (note 148) 347.



In addition to the utilization as accounting entity partnerships are in Germany also treated as entity for the purpose of characterizing the income.<sup>174</sup> The partnership carries out the taxable activity as representative for all partners.<sup>175</sup> In Germany different provisions and tax consequences are allocated to different sources of income.<sup>176</sup> Thus, In order to determine whether the income is taxable and according to which provisions, common criteria apply for the characterization of the source of income at the level of the partnership which may then result in a partnership carrying out a trade or business<sup>177</sup>, a freelance partnership<sup>178</sup> or even a partnership earning capital income or income from rent and lease<sup>179</sup>. To each of these forms of partnerships the above entity approach generally applies, however, the type of income ultimately taxed in the hands of the respective partners and the applicable provisions, also those referring to the determination of the income at the partnership level, may vary accordingly.<sup>180</sup> Provided the partnership carries out a trade or business, s 15 (1) No 2 applies and the partner earns business income according to its share in the partnership if he can be regarded as an entrepreneur of the latter.<sup>181</sup>

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<sup>174</sup> Rijkele (note 137) Germany-Partnerships 5.3.1..

<sup>175</sup> Jakob (note 148) 327.

<sup>176</sup> Jakob (note 148) 24. As set out in s 2 (1) of the Income Tax Act, only specifically enumerated sources of income are subject to tax.

<sup>177</sup> See s 15 (2) of the Income Tax Act for the features of a business partnership. These business partnerships are referred to as 'Mitunternehmerschaft' and subject to s 15 I No 2 of the Income Tax Act. Section 15 (3) No 2 renders every partnership a business partnership, whatever income it actually earns, if it consists of a corporation as the only general partner, and if this corporation or a non-partner is also the authorised manager of the partnership. This regularly applies to the German GmbH & Co KG. See Jakob (note 148) 328.

<sup>178</sup> See s 18 (1) of the Income Tax Act. These partnerships are nevertheless treated like business partnerships and are subject to the same provisions.

<sup>179</sup> See s 20 or 21 of the Income Tax Act.

<sup>180</sup> Jakob (note 148) 327-9; see also footnote 219.

<sup>181</sup> Jakob 321-3. Referred to as 'Mitunternehmer' in Germany. In this respect, specific qualities, like 'Mitunternehmerisiko' and Mitunternehmerinitiative', are required of the partner in order to be regarded as entrepreneur. Provided this is fulfilled, s 15 (1) No 2 applies and allots the profits of the partnership to the respective partner according to its share after being determined at the level of the partnership.

Section 15 (1) No 2 would also apply in case of a freelance partnership (s 15 (1) No 2 read with s 18 (4) of the Income Tax Act) and even if the partnership would carry out activities of agriculture and forestry (s 15 (1) No 2 read with s 13 (7) of the Income Tax Act). Both forms of income are like business income regarded as 'profit income' ('Gewinneinkünfte') and are subject to the same provision for the determination of the taxable income (s 2 (2) No 1 of the Income Tax Act).

However, in case of a partnership that earns capital income or income from rent and lease s 15 (1) No 2 is not applicable. Besides, unlike profit income, they are subject to s 2 (2) No 2 of the Income Tax Act for the purpose of determining their taxable income.

In Short, the partnership is in Germany treated as independent entity for accounting and income characterization purposes.

Other countries, however, ignore the partnership completely for tax purposes and regard it as `the aggregation of the partners` businesses`<sup>182, 183</sup> According to that `aggregate approach`<sup>184</sup> the taxation and the computation of the income takes place at the partner`s level only.<sup>185</sup> The accounting elections are carried out at the same level.<sup>186</sup> The partnership is fiscally not existent<sup>187</sup> and the income reported by the partnership of no relevance for the taxation of the partner`s income.<sup>188</sup> Insofar the aggregate approach corresponds to the `Bilanzbündel`<sup>189</sup> theory, applied in Germany prior to the `entity approach` described above. Insofar each partner is regarded as carrying out its own business according to its share of the total business of the partnership.<sup>190</sup>

It has to be considered that the entity approach is without prejudice to the general transparency principle. The partnership might thus be utilized as entity in some ways, it is, however, still regarded as transparent concerning the taxation of the income and leaves the partner as only taxpayer, liable and subject to income or corporate tax.<sup>191</sup> The entity approach for the purpose of accounting and characterizing the income is in this respect rather of technical relevance and shall not influence the general recognition of a partnership as fiscally transparent.<sup>192</sup>

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<sup>182</sup> Daniels (note 127) 28.

<sup>183</sup> For instance the Netherlands and Italy. See Brincker (note 154) 560. Some countries, like Sweden, have chosen a middle course between the aggregate and the entity approach. See Barenfeld (note 27) 74-5

<sup>184</sup> Daniels (note 127) 29.

<sup>185</sup> Barenfeld (note 27) 74..

<sup>186</sup> Daniels (note 127) 29

<sup>187</sup> Barenfeld (note 27) 74.

<sup>188</sup> Daniels (note 127) 29.

<sup>189</sup> See footnote 170.

<sup>190</sup> Jakob (note 148) 336-337; Daniels (note 127) 29.

<sup>191</sup> Barenfeld (note 27) 74, Jakob (note 148) 337. See also OECD Partnership Report (note 1) 14. It was specifically dealt with that issue in the context of the application of the OECD MTC to partnerships. See chapter D section II a) aa) (1) in this study.

<sup>192</sup> Jakob (note 148) 337.

In contrast to the transparency principle applied in Germany there are also countries which treat partnerships as non-transparent separate corporations for tax purposes.<sup>193</sup> In this respect the partnership itself is regarded as liable to tax and seen as own taxable entity paying its taxes and declaring them accordingly like a corporation.<sup>194</sup> The shareholder is then taxed upon distribution of the entities' profits.<sup>195</sup> Countries applying such an approach are for instance Bolivia, Brazil, Chile and Colombia.

Other countries even provide for an election as to the tax treatment of the entity as non-transparent corporation or transparent entity.<sup>196</sup>

#### **IV. The general difference in taxation of fiscally transparent and fiscally non transparent entities.**

With regard to business entities seen as fiscally transparent, income passes through to the partners and is subject to tax in their hands only.

Germany applies a 'single tax pattern'<sup>197</sup> to partnerships and taxes the income only once at the level of the partners.<sup>198</sup> Any succeeding distribution of income is insofar of no relevance for the taxation as it was already taxed in the hands of the partners. The distribution is rather regarded as 'transfers of previously taxed funds'<sup>199</sup> or non-taxable withdrawals<sup>200</sup> and therefore ignored for German tax purposes.<sup>201</sup> Accordingly, the income 'is subject to full and final taxation when earned' at the level of the partner.<sup>202</sup>

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<sup>193</sup> Jacobs (note 164) part 4 chapter 4 A. I. 1. b. Referred to as 'non-transparency approach' and particularly applied by countries with a Roman concept of law like Belgium, Spain Portugal and Latin American countries. See Daniels (note 127) 8.

<sup>194</sup> Frotscher (note 4) 170; Brincker (note 154) 550. For the general taxation of corporations see chapter C. section IV.

<sup>195</sup> Brincker (note 154) 552.

<sup>196</sup> See elective approach discussed in chapter C section V 2. b) in this study.

<sup>197</sup> Barenfeld (note 27) 98.

<sup>198</sup> Jakob (note 148) 320.

<sup>199</sup> OECD Partnership Report (note 1) 49.

<sup>200</sup> Rijkele (note 137) Germany-Partnerships 5.1.2..

<sup>201</sup> Barenfeld (note 27) 98.

<sup>202</sup> Barenfeld (note 27) 98-99.

With respect to business entities seen as a taxpayer separate from its members, however countries generally pursue a 'double-tax pattern'<sup>203, 204</sup>.

Contrary to partnerships, corporations are in Germany considered as juridical person with own legal personality in civil and commercial law and regarded as independent taxpayer for income tax purposes.<sup>205</sup> According to s 1 of the German Corporate Tax Act a corporation itself constitutes a person liable to unlimited taxation on its income<sup>206, 207</sup>. As long as this income is retained by the corporation, its shareholder is not involved for tax purposes. Only on distribution the shareholder's respective share of the income is subject to taxation.<sup>208</sup> This system therefore implicates economic double taxation which can be summarized as:

'The imposition of tax on the same income in the hands of different taxpayers'<sup>209</sup>.

The income of the corporation is subject to corporate tax at its level. This income distributed is referred to as dividends and subject to tax at the level of the shareholder upon distribution. Hence the economic result is taxed twice in the hands of the corporation and on distribution in the hands of the individual shareholder.

Countries' domestic tax systems deal differently with economic double taxation and entertain different tax concepts dealing with the corporate tax at the entity level and/or the dividend tax at the shareholder level.<sup>210</sup> As a result of these different approaches the double taxation may be relieved completely in some countries and in others only partly.<sup>211</sup> Still other countries do not provide any method and leave the double taxation completely unrelieved.<sup>212</sup>

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<sup>203</sup> Barenfeld (note 27) 93.

<sup>204</sup> Jakob (note 148) 319. In Germany referred to as 'Trennungsprinzip'. Usually applied regarding corporations, however by some countries also pursued with respect to partnerships. See footnote 193.

<sup>205</sup> Jakob (note 148) 355-6; Frotscher (note 4) 196.

<sup>206</sup> Income in terms of s 7 Corporate Tax Act.

<sup>207</sup> According to s 2 No 1 Corporate Income Tax Act a corporation may be subject to limited taxation if it has neither legal seat nor place of effective management in Germany.

<sup>208</sup> According to s 20 (1) No 1 Income Tax Act in case of an individual as shareholder. In case of a corporation as shareholder s 8b (1) and (5) of the Corporate Tax act apply and exempt 95% of the dividends from corporate tax.

<sup>209</sup> Barenfeld (note 27) 86; similar Frotscher (note 4) 5-6.

<sup>210</sup> Barenfeld (note 27) 93-94.

<sup>211</sup> Barenfeld (note 27) 93-94.

<sup>212</sup> Barenfeld (note 27) 94.

In this respect Germany applies a partial income method as from 2009. This concept was introduced after the business tax reform 2008 in order to replace the former half income method <sup>213</sup>, according to which only half of the dividends income and capital gains from equity participations were subject to tax<sup>214</sup> and only half of the expenditures deductible<sup>215</sup>.

Like the half income method the newly introduced method is aiming at avoiding double taxation of distributed profits which were already subject to taxation at the level of the corporation.

However, in contrast to the former concept, it differentiates between business assets and private assets and exempts only 40% of the dividends income and capital gains from taxation.<sup>216</sup>

Besides, the legislator reduced the corporate tax rate levied at the level of the corporation from 25% to 15%, which in turn is compensated through the increase of the taxability of the dividends income and capital gains from 50% under the former half income method to 60% under the new method.

The latter, like the replaced former method, nevertheless only applies to dividends income and capital gains received from natural persons.

With regard to corporations as shareholders s 8b Corporate Tax Act applies, according to which the dividends income and capital gains derived from equity participations are, except for 5% of the dividends and the gains, exempt from corporate tax.

## **V. Entity classification**

As set out above, fiscally transparent and fiscally non-transparent entities are subject to different taxation rules. Entities may be classified as partnerships or corporations for tax purposes. Like Germany, many countries tax partnerships according to a

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<sup>213</sup> Jakob (note 148) 319.

<sup>214</sup> Previous s 3 No 40 Income Tax Act.

<sup>215</sup> Previous s 3c (2) Income Tax Act.

<sup>216</sup> Section 3 No 40 of the Income Tax Act. According to s 3 c (2) of the Income Tax Act only 60% of the expenditures are deductible.

single tax pattern.<sup>217</sup> In contrast, corporations are commonly subject to a double tax pattern.<sup>218</sup> The entities treatment for tax purposes therefore generally depends on the countries` classification of the entity as partnership or corporation.

In this respect the classification of a domestic and a foreign entity must be distinguished.

In each case the point of departure constitute the German classification rules.

### **1. Classification of domestic entities**

For German tax purposes domestic taxable entities are strictly defined in s 1 of the Corporate Tax Act, which enumerates domestic entity<sup>219</sup> types to be considered as corporations and to be taxed accordingly.<sup>220</sup> Among other entity forms, the provision lists the public limited company, the limited liability company and the partnership limited by shares and includes others, like the European company.<sup>221</sup> As the enumeration is final<sup>222</sup> other entities are not considered corporations and therewith not subject to the double-tax pattern.<sup>223</sup>

The list is strictly based on the civil law organizations and therefore subject to a form over substance approach.<sup>224</sup> An entity formed under the Limited Liability Company Act, like the limited liability company can accordingly never be regarded as a partnership, and a partnership formed under the Commercial Code or the Civil Law Code can never be taxed as a corporation.<sup>225</sup> For tax purposes the form takes insofar precedence over the substance of the business vehicle and even partnerships with corporate characteristics and conversely corporations with partnership characteristics are still to be classified according to their form of organization.<sup>226</sup> Hence, one man

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<sup>217</sup> There are, however countries which tax partnerships according to a double tax pattern, as they treat partnerships like corporations for tax purposes. See footnote 193.

<sup>218</sup> See in this study chapter C section IV.

<sup>219</sup> Entities which have their legal seat or place of effective management in Germany. See Frotscher (note 4) 171.

<sup>220</sup> See s 2 (1) of the Corporate Tax Act.

<sup>221</sup> Section 1 (1) of the Corporate Tax Act.

<sup>222</sup> Frotscher (note 4) 197.

<sup>223</sup> Rijkele (note 137) Germany-Partnerships 5.1.1..

<sup>224</sup> The USA, France or Canada for instance. See Daniels (note 127) 16 and Brincker (note 154) 558-9.

<sup>225</sup> Rijkele (note 137) Germany-Partnerships 5.1.1..

<sup>226</sup> Rijkele (note 137) Germany-Partnerships 5.1.1..

entities<sup>227</sup> are considered as a corporation and a compound entity<sup>228</sup> treated as a partnership for German tax purposes.<sup>229</sup>

Considering the above, the German form over substance approach promotes predictability and certainty as to the tax treatment of a domestic entity, since the domestic or foreign investor<sup>230</sup> may choose an entity form and simultaneously predict its classification for tax purposes.<sup>231</sup>

The German classification of its domestic entity is nevertheless without prejudice to the foreign country's classification.<sup>232</sup> The German entity may be classified and treated differently in a foreign country.<sup>233</sup>

In contrast to the German classification of domestic entities, other countries take the substance of business entities into consideration when classifying them for tax purposes<sup>234</sup> or even amending their legislation in order to provide for an election as to the entity's tax classification.<sup>235</sup> In the USA, for instance, the definition of corporations in its Corporate Tax Act was rather vague and hence allowed more room for the consideration of entities' specific features in order to classify them for domestic tax purposes.<sup>236</sup> The USA focused on specific corporate features to distinguish partnerships from corporations and was insofar not confined to listed entities based on their Civil Law form.<sup>237</sup>

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<sup>227</sup> A corporation which is wholly owned by one person.

<sup>228</sup> A partnership with corporate characteristics. Referred to as 'GmbH&Co KG'. See chapter C section II in this study.

<sup>229</sup> Jakob (note 148) 321.

<sup>230</sup> The classification rules apply also to domestic companies with foreign taxpayers as members. See Rijkele (note 137) Germany-Partnerships 1.5.1..

<sup>231</sup> Rijkele (note 137) Germany-Partnerships 1.5.1..

<sup>232</sup> Where the investor of the entity resides, or the source of income is situated. See chapter C section V 2. In this study.

<sup>233</sup> For the discussion of such conflicts of qualification chapter C section VI in this study.

<sup>234</sup> Rijkele (note 137) Germany-Partnerships 5.1.1..

Referred to as 'Substance over form' approach.

<sup>235</sup> See 'check the box' regime, adopted by the USA.

<sup>236</sup> Daniels (note 127) 10-11.

<sup>237</sup> Daniels (note 127) 15, 17-23. Developed according to *Kintner v United States*, 216 F2d 418 (9<sup>th</sup> Cir.1954) and referred to as the 'Kintner regulations'. The Netherlands also classify their domestic entities according to specific features instead of relying on the form of the entity.

In order to simplify its legislation in this respect it adopted in 1997 the 'check the box' regime according to which the domestic entity is able to choose its tax status<sup>238 239</sup>.

## 2. Classification of foreign entities.

There are basically two different situations where foreign entities<sup>240</sup> have to be classified from a domestic country perspective:

- if the owner of a foreign entity is a resident taxpayer in a classifying domestic country<sup>241</sup>, and
- if the foreign entity receives income attributable to a source in the classifying domestic country.

In these situations the fundamental question arises whether the foreign entity can be classified as a corporation subject to the double-tax pattern or as a partnership usually taxable under a single-tax pattern.<sup>242</sup>

Countries' classification rules may be based on elaborated statutory provisions, on more or less developed case law, or on neither of these sources, leading to unpredictability and uncertainty from the taxpayer's and tax authorities' point of view.<sup>243</sup>

In some countries, like in Germany, 'administrative guidance' from countries' tax authorities or other governmental bodies are added to the basic rules in order to fill gaps relating to the classification process.<sup>244</sup>

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<sup>238</sup> Either as fiscally transparent or fiscally non-transparent corporation.

<sup>239</sup> Thies Kroniger 'Anwendung des check the box-Systems auf die KGaA als Joint Venture-Vehikel' (2002) 12 *IStR* 397 at 400; Barenfeld (note 27) 119. The 'check the box' regime is also applicable to foreign entities. Insofar chapter C V 2. b) in this study.

<sup>240</sup> Entities with legal seat or place of effective management in a foreign country. See Frotscher (note 4) 171.

<sup>241</sup> This example corresponds to the 'Outbound' and the 'Inbound' situation discussed in chapter D in this study.

<sup>242</sup> Some countries treat partnerships like corporations and tax them according to a double-tax pattern.

<sup>243</sup> Barenfeld (note 27) 108-111.

<sup>244</sup> Like the German Ministry of Finance circular of 24 December 1999 87-93. Quoted in Barenfeld (note 27) 110.



The methods pursued for the classification of foreign entities vary considerably between countries.<sup>245</sup>

However, the following three main methods may be distinguished, despite the varying details and criteria used within each of these.<sup>246</sup>

### **a) Similarity Approach**

The Similarity approach is generally based on a 'resemblance' test requiring the examination of a foreign entity's features and the comparison of these features with the characteristics of domestic business types.<sup>247</sup> The tax treatment applicable to the domestic business type most similar to the foreign entity is then applied to the foreign entity for domestic tax purposes.<sup>248</sup>

Like in many other countries<sup>249</sup> this approach is also pursued by Germany.<sup>250</sup>

In this respect German legislation, however, lacks statutory provisions.<sup>251</sup>

Section 1 (1) of the Corporate Tax Act that provides for a strict definition of corporations for German tax purposes is confined to entities organized under domestic law<sup>252</sup> and neither German tax law nor any German DTC contains expressed rules regarding the classification of entities organized under foreign law.<sup>253</sup>

The German similarity approach is nevertheless based on domestic case law and insofar particularly on the 'Venezuelan case'<sup>254</sup> whose developed principles and

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<sup>245</sup> Daniels (note 127) 99; Frotscher (note 4) 171.

<sup>246</sup> Barenfeld (note 27) 111.

<sup>247</sup> Barenfeld (note 27) 112.

<sup>248</sup> Barenfeld (27) 112.

<sup>249</sup> For instance England and Sweden. See Barenfeld (27) 112.

<sup>250</sup> Referred to as 'Typenvergleich' in Germany. See Frotscher 172; Marion Müller and Clemens Wangler 'Qualifikationskonflikte bei der Beteiligung inländischer Investoren an ausländischen Personengesellschaften' (2003) 5 *IStR* 145 at 146.

<sup>251</sup> Frotscher (note 4) 197.

<sup>252</sup> S 1 (1) of the German Corporate Tax Act.

<sup>253</sup> Frotscher (note 4) 197.

<sup>254</sup> RFH 2.2.1930 RStBl. 1930 444. Quoted in Barenfeld (note 27) 112.

rules are applicable law until today and accordingly recognized and followed by the German jurisdiction, the fiscal authorities and legal scholars.<sup>255</sup>

This case dealt with the classification of a Venezuelan limited partnership which was treated as a taxable entity under its local law. The court found that its legal features correspond to the legal characteristics of a German limited partnership and must accordingly be treated as a partnership and therewith fiscally transparent for German tax purposes.

The question is therefore, whether the foreign entity, according to its features and its economic function attributed in the foreign country, more resembles a German corporation<sup>256</sup> or a German partnership.<sup>257</sup> For German tax purposes the entity is then treated either as a taxable corporation or as a fiscally transparent partnership, as the case may be. The German similarity method can therefore be summarized as referring to the legal features of a foreign entity comparing them to the domestic legal features of German entities and then applying the tax treatment applicable to the entity most resembling the foreign entity under examination.<sup>258</sup>

The American Limited Liability Company (LLC) may accordingly, depending on its design and German counterpart, constitute a partnership or a corporation for German tax purposes.<sup>259</sup>

The tax treatment of the foreign entity in its home country is in this respect of no relevance for the German classification.<sup>260</sup>

By the same token, elections as to the tax treatment in the foreign country cannot be taken into account.<sup>261</sup>

Following the above example, an American LLC would therefore still be classified according to its German counterpart even if the taxpayer wanted it to be treated as a corporation in the USA<sup>262</sup>.

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<sup>255</sup> Frotscher (note 4) 172, 198.

<sup>256</sup> Frotscher (note 4) 198-199.

<sup>257</sup> Frotscher (note 4) 198.

<sup>258</sup> Müller and Wangler (note 250) at 146.

<sup>259</sup> Frotscher (note 4) 172.

<sup>260</sup> Daniels (note 127) 104; Barenfeld (note 27) chapter 8. The Swedish similarity approach considers the tax law characteristics of the foreign entity at least as one of the factors when classifying it for domestic tax purposes.

<sup>261</sup> Rijkele (note 137) Germany-Partnerships 5.1.2..

As indicated above the general law, as opposed to the tax law characteristics of the foreign entity constitute the point of departure for classifying it for domestic tax purposes.<sup>263</sup>

Typical for partnerships is insofar that at least one of the partners has unlimited liability<sup>264</sup>, that the management is carried out by the partners themselves, that the partnership may be subject to termination upon death or withdrawal of a partner and that the ownership is not transferable.<sup>265</sup>

A corporation, in contrast, usually features limited liability, a management carried out by non-members, indefinite existence and freely transferable ownership.<sup>266</sup> Moreover it is regarded as legal entity with legal capacity separate from its members and should thus perform accordingly in its home country.<sup>267</sup>

In view of these main characteristics the German public limited company and the general partnership may be regarded as representing the decisive elements of a corporation and a partnership respectively and may insofar be taken into account as a point of departure when characterizing foreign entities for German tax purposes.<sup>268</sup>

Considering the features of the general partnerships from Hong Kong, Ireland, Canada, Nigeria, USA and the unlimited company from South Africa, these foreign entities directly conform to the German general partnership (OHG).<sup>269</sup>

However, strict conformity of a foreign entity with the features of a German entity type can be achieved only in rare cases.<sup>270</sup> The similarity approach therefore only requires conformity to the greatest extent possible.<sup>271</sup>

The countries' domestic entities and their features to be considered in the classification process may vary between countries.<sup>272</sup> As the similarity approach is

<sup>262</sup> According to the American 'check-the-box' regime.

<sup>263</sup> Barenfeld (note 27) 113.

<sup>264</sup> Daniels (note 127) 104.

<sup>265</sup> Frotscher (note 4) 198; see also chapter C section II in this study.

<sup>266</sup> Rijkele (note 137) Germany-Partnerships 5.1.2.; Daniels (note 127) 104; Frotscher (note 4) 198.

<sup>267</sup> Frotscher (note 4) 198.

<sup>268</sup> Daniels (note 127) 103.

<sup>269</sup> Jacobs (note 164) part 4 chapter 4 1. b).

<sup>270</sup> Jacobs (note 164) part 4 chapter 4 1. a) (1).

<sup>271</sup> Jacobs (note 164) part 4 chapter 4 1. a) (1).

<sup>272</sup> Barenfeld (note 27) 112.

based on a comparison between these features it may easily result in an entity being regarded as non-transparent corporation according to the foreign country's perspective and as fiscally transparent for domestic tax purposes, hence in a conflict of qualification.<sup>273</sup> By the same token, the method as such may also be applied differently by different countries and can therefore lead to different results with respect to the same foreign entity, depending on the country applying the similarity approach.<sup>274</sup> These issues especially arise with regard to partnerships, as their general law features and their tax treatment vary to a great extent between countries' jurisdictions.<sup>275</sup>

As the similarity approach requires knowledge of foreign law and results only in rare cases in strict conformity with domestic entity types it may, particularly in borderline cases<sup>276</sup>, be difficult to apply the approach in practice which may insofar give rise to some uncertainty and unpredictability in the classification process from the taxpayer's and the fiscal administration's point of view.<sup>277</sup>

In order to allow for a consistent classification of foreign entities also in more difficult cases the German tax administration therefore made up and released a list which aims at allocating foreign entities to domestic entity types with similar features.<sup>278</sup> The tax administration updates this list regularly by also including newly introduced entity types.<sup>279</sup> Similar efforts are made by the OECD which released an overview of the features and tax treatment of the member states' entities.<sup>280</sup> These guidelines may be of assistance for taxpayers or fiscal administrations when determining the tax treatment of foreign entities for domestic tax law purposes and increasing certainty and predictability in this regard.<sup>281</sup>

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<sup>273</sup> See chapter C section VI and chapter D in this study.

<sup>274</sup> Jacobs (note 164) part 4 chapter 4 1. b). For example, Belgium considers 'legal personality' as a main feature of a domestic corporation and accordingly considers the same feature to be determinative as to whether the foreign entity constitutes a corporation for domestic tax purposes. In contrast, Sweden focuses on 'legal capacity' as the decisive feature for classifying a foreign entity as corporation subject to the double-tax pattern. See Barenfeld (note 27) 112-113.

<sup>275</sup> Barenfeld (note 27) 112.

<sup>276</sup> For instance cases, where the entity features both corporate and partnership characteristics.

<sup>277</sup> Daniels (note 127) 104; Müller and Wangler (note 250) 147.

<sup>278</sup> Müller and Wangler (note 250) 147.

<sup>279</sup> Rijkele (note 137) Germany-Partnerships 5.1.2..

<sup>280</sup> Müller and Wangler (note 250) 147.

<sup>281</sup> Barenfeld (note 27) 110.

The level of certainty and predictability for tax purposes is therefore dependant on the clarity of rules and principles developed by the domestic legislation or jurisdiction.

## **b) Elective Approach**

Other countries pursue an approach, which basically allows the taxpayer to decide whether the entity shall be classified as a fiscally transparent partnership or as a taxable corporation for domestic tax purposes.<sup>282</sup>

This approach can best be illustrated by the American 'check the box' regime adopted by the USA in 1997.<sup>283</sup> The determination of how to characterize a foreign entity for U.S. tax purposes was previously based on a somewhat subjective four-factor corporate resemblance test and has been rather a confused area of U.S. tax law.<sup>284</sup> Therefore, in order to provide for more simplicity and certainty in this respect the USA introduced the elective regime as a new classification regulation.<sup>285</sup>

The new American 'check-the-box' regime which generally applies to domestic as well as foreign entities<sup>286</sup>, allows certain business entities to elect their classification for US tax purposes.<sup>287</sup> The power to decide as to the classification of the entity is accordingly handed over to the taxpayer<sup>288</sup> and may result in a classification as partnership, as disregarded entity ('branch'<sup>289</sup>) or corporation ('association'<sup>290</sup>).<sup>291</sup>

Partnerships and disregarded entities are both ignored for US tax purposes and accordingly treated as fiscally transparent.<sup>292</sup> The corporation, in contrast, is considered a taxable entity.<sup>293</sup> Insofar the system resembles the German tax

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<sup>282</sup> Köhler *Konzernsteuerrecht* 2ed (2008) § 8 Konzernstruktur und Umstrukturierung margin number 72-73.

<sup>283</sup> Kroniger (note 239) 400.

<sup>284</sup> See Daniels (note 127) for a detailed discussion 10-15; See also Kroniger (note 239) 400.

<sup>285</sup> Kroniger (note 239) 400.

<sup>286</sup> Barenfeld (note 27) 119.

<sup>287</sup> Jacobs (note 164) chapter 3 1..

<sup>288</sup> Barenfeld (note 27) 119.

<sup>289</sup> Kroniger (note 239) 401.

<sup>290</sup> This term used for corporations in the US legislation. See Kroniger (note 239) 401.

<sup>291</sup> Kroniger (note 239) 401.

<sup>292</sup> Kroniger (note 239) 400.

<sup>293</sup> Kroniger (note 239) 400.

classification.<sup>294</sup>

However, the basic right to elect does only apply to 'eligible entities'<sup>295</sup>, ie entities constituting a 'separate business entity' and not regarded as 'per se'-corporations. A 'separate business entity' may be assumed if the participants' association is based on a contractual agreement and aimed at carrying out business or financial activities or if the association constitutes a joint venture aiming at sharing profits.<sup>296</sup> Associations which only aim at the sharing of costs or pure property administration do not satisfy these requirements<sup>297</sup> and are therefore not subject to the election provided for by the 'check-the box' regime.

Per se - corporations<sup>298</sup> are entity types which are required to be treated as corporations and may either be American entities organized as corporations according to the US federal or state law<sup>299</sup> or foreign corporation types referred to in a list integrated in the US legislation<sup>300</sup>. The List considers about 80 foreign entities, representing 80 countries<sup>301</sup> and includes for instance, the United Kingdom Public Limited Company, the French Societe Anonyme and the German Public limited company.<sup>302</sup> It does, however, not include the German Limited Liability Company which is regarded as corporation in Germany just like the included Public limited Company.<sup>303</sup> Accordingly the list may be regarded as rather limited to the main corporation types in each country treated as taxable entities according to their domestic tax law.

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<sup>294</sup> See in this study chapter C section III.

<sup>295</sup> Kroniger (note 239) 401.

<sup>296</sup> Treas. Reg. § 301.7701-1(2).

<sup>297</sup> Treas. Reg. § 301.7701-1(a)(2).

<sup>298</sup> Treas. Reg. § 301.7701-2(a), -3(a).

<sup>299</sup> Jacobs (note 164) chapter 1 1.; Barenfeld (note 27) 119; see also Treas. Reg. § 301.7701-2(b)(1) bis (6) in conjunction with section 7704 IRC.

<sup>300</sup> Treas. Reg. § 301.7701-2(b).

<sup>301</sup> In certain countries like Canada, Mexico, Cyprus, Hong Kong, Jamaica, India and Malaysia there are however also clarifications regarding further entity types. See Treas. Reg. s 301.7701-2(b)(8)(ii), (iii), (iv)).

<sup>302</sup> Treas. Reg. § 301.7701-2(b)(8)(i).

<sup>303</sup> Jacobs (note 164) chapter 1 1..

In case the taxpayer fails to utilize the check-the box system, a 'default classification' takes place, based on the number of owners and the status of their liability.<sup>304</sup>

The relevance of the American check the box system for German tax purposes is obvious, considering cases of a German resident participating in an American entity or an American resident investing in a German entity.<sup>305</sup>

Only recently the German BFH in fact dealt with one of these cases and had to determine the income of a German individual who participated in a US-Limited Liability Company (LLC) chosen to be classified as a partnership for US tax purposes.<sup>306</sup> The LLC was, however, held to be regarded as corporation under German tax law, which resulted in a conflict of qualification between the states involved.<sup>307</sup>

The elective approach simplifies the classification process by relieving the tax administration from doing research and gathering knowledge about foreign entities.<sup>308</sup> Insofar the approach leads to certainty as to the tax consequences, which in turn makes the outcome more predictable for both the taxpayers and the tax administration.<sup>309</sup>

However, the power of choosing the entity's tax treatment entails great flexibility from a tax planning point of view and may, as experienced in the USA<sup>310</sup>, also be used by taxpayers for extensive tax avoidance through the use of hybrid entities<sup>311, 312</sup>. The prevention of such negative effects requires the adoption of strict and probably complex rules and would insofar counteract the actual simplicity of the check the box

<sup>304</sup> Treas. Reg. S. 301.7701-3(b).

<sup>305</sup> Jacobs (note 164) chapter 3 1.. See insofar also the 'Inbound' and 'Outbound' situation, discussed in chapter D in this study.

<sup>306</sup> Gero Burwitz 'Einkünfte aus Beteiligung an US – LLC' (2008) 23 *Neue Zeitschrift für Gesellschaftsrecht (NZG)* 903 at 903.

<sup>307</sup> Burwitz (note 306) 903. For qualification conflicts see chapter C VI and chapter D in this study. In the examples discussed in chapter D the foreign entity is however regarded as fiscally transparent partnership for German tax purposes. The reverse case is not further dealt with in this study.

<sup>308</sup> Jacobs (note 148) chapter 3 1.; Barenfeld (note 27) 121.

<sup>309</sup> Barenfeld (note 27) 121.

<sup>310</sup> Barenfeld (note 27) 121-122.

<sup>311</sup> Jacobs (note 148) part 6 chapter 7 B. VII. Hybrid entities are entities classified differently for tax purposes in different countries and are the result of qualification conflicts. See insofar also chapter C section VI and chapter D in this study.

<sup>312</sup> Jacobs (note 148) chapter 3 1..

regime.<sup>313</sup> As regards to the USA, it remains to be seen whether and how it will tighten its 'check the box' legislation in this respect.<sup>314</sup>

### c) Fixed Approach

Finally some countries pursue a fixed approach when classifying foreign entities. Accordingly all foreign entities are classified for tax purposes in the same way, either as fiscally transparent or as taxable corporate entity.<sup>315</sup> Italy and Finland, for instance, characterize foreign companies and entities of any type as corporations and treat them accordingly as taxable entities for their domestic tax purposes.<sup>316</sup>

As this approach is based on the same treatment of foreign entities in each case it facilitates predictability and certainty as to the tax treatment, particularly for taxpayers who consider an investment in a foreign entity.<sup>317</sup> By the same token it provides for simplicity from a tax administration's point of view as the approach only requires compliance with the fixed treatment of foreign entities without involving the collection of legal information about the foreign entity form.<sup>318</sup> On the other hand the approach makes no effort to consider the features of the foreign entity which increases the chances of a classification diverging from the foreign country.<sup>319</sup>

## VI. Origin of qualification conflicts

In general a qualification conflict refers to a situation where identical facts are treated differently for tax purposes in different countries.<sup>320</sup> Such a conflict may either concern the subject<sup>321</sup> or the object of taxation<sup>322, 323</sup>.

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<sup>313</sup> Barenfeld (note 27) 121-123.

<sup>314</sup> Jacobs (note 148) chapter 3 1..

<sup>315</sup> Barenfeld (note 27) 123.

<sup>316</sup> Brincker (154) 559 and 560; Rijkele (note 137) Italy-Partnerships 5.1..

<sup>317</sup> Barenfeld (note 27) 124.

<sup>318</sup> Barenfeld (note 27) 124.

<sup>319</sup> Barenfeld (note 27) 124. See insofar also chapter C section VI in this study.

<sup>320</sup> Jacobs (note 164) chapter 7 A.

<sup>321</sup> Helmut Debatin 'Zur Behandlung von Beteiligungen an Personengesellschaften unter den Doppelbesteuerungsabkommen im Lichte der neueren Rechtsprechung des Bundesfinanzhofs' (1992)



As regards to the object of taxation, two or more countries may classify income derived by a domestic partner from a foreign partnership differently despite the common classification of the entity itself.<sup>324</sup>

However, focus of this study is a 'subject divergence conflict', where the same entity is classified or treated 'differently in two or more countries'<sup>325</sup>. Entities regarded as corporation are themselves liable and subject to tax. Entities classified as partnership are, however, usually seen as fiscally transparent. Instead its partners are considered liable and subject to tax. Therefore, if countries classify the same entity differently, as non-transparent in one country and as fiscally transparent in the other country, they are in conflict regarding the subject of taxation.<sup>326</sup> The same applies to entities, regarded in both countries as partnership but treated differently as non-transparent in one country and fiscally transparent in the other country.<sup>327</sup>

It is however still to be clarified what in fact gives rise to these conflicts regarding the tax classification of entities.

Firstly, point of departure for classifying a domestic or foreign entity and determining its taxability always constitutes the domestic tax law of the respective classifying or taxing country usually without consideration of the entity's tax

*Betriebs Berater (BB)* 1181 at 1181. Referred to as 'subject divergence conflict'. See Stephan Gündisch 'Solving Conflicts of Qualification by Analogous Application of Tax Treaties' *IBFD* (2003) *Bulletin-Tax Treaty Monitor* 424 at 426. Referred to as 'subject divergence conflict'. In Germany referred to as 'subjektiver Qualifikationskonflikt'.

<sup>322</sup> Referred to as 'object divergence conflict'. See Gündisch (note 321) at 426. In Germany referred to as 'objektiver Qualifikationskonflikt'.

<sup>323</sup> The OECD Partnership Report 1999 deals with both issues. The main part however focuses on qualification conflicts regarding the subject of taxation. See OECD Partnership Report (note 1) part II.

<sup>324</sup> Jacobs (note 164) part 4 chapter 4 A. II. This constitutes a particular issue in Germany. According to German tax law guaranteed payments paid by the partnership and derived by a partner are always treated as business income falling under s 15 (1) No 2 of the German Income tax Act. Insofar Art 7 generally applies for tax treaty purposes in cross-border situations. However, most countries treat guaranteed payments according to the nature of such payments. Interests paid by the partnership on loans provided by the partner are accordingly treated as interests and not as business profits. In a cross border situation the contracting countries might therefore apply different articles of a DTC with respect to the same income. This can affect the application of a DTC and give rise to double taxation or double non-taxation of the guaranteed payments. One part of the Partnership Report addressed this specific issue. Its analysis in this study would, however, extend what is possible to deal with. It is therefore not further analyzed.

<sup>325</sup> Barenfeld (note 27) 103. The entity resulting from such a conflict is referred to as 'hybrid' entity. See footnote 311. This type of conflict is dealt with throughout this study and hereinafter referred to as 'qualification conflict'.

<sup>326</sup> Hans Gummert and Lutz Weipert *Münchener Handbuch des Gesellschaftsrechts* 2ed vol 2 (2004) §58 Ertragsteuern margin number 493.

<sup>327</sup> Frotscher (note 4) 170; Gummert and Weipert (note 326) margin number 494.

treatment in the foreign country.<sup>328</sup> As indicated, the classification rules as such, vary considerably between countries.<sup>329</sup>

Some countries, like Germany, consider the civil form of domestic entities as decisive for its tax classification. Other countries rather focus on various general law features of the entity in order to determine its classification for tax purposes. Again other countries offer the domestic entity an election as to its tax classification.

As regards the classification of foreign entities the countries also apply different methods. Insofar the similarity approach, the elective approach and the fixed approach can be distinguished.<sup>330</sup>

Neither the classification of domestic, nor the classification of foreign entities, however, considers the tax treatment of the entity in the foreign country. Therefore they may all give rise to qualification conflicts.<sup>331</sup> The elective approach even facilitates the utilization of such conflicts by providing for an election as to the entity's tax treatment irrespective of its treatment in the other country.

As a result, the classification may lead to an entity regarded as partnership transparent for tax purposes in one country and as non-transparent corporation in the other country, hence in a conflict regarding the qualification of the subject of taxation.

A Chilean 'sociedad de responsabilidad limitada', for instance, although regarded as partnership in its country of organization, is not recognized as such in Germany, but rather considered a corporation when compared to the features of German entity types.<sup>332</sup>

By the same token, an American LLP will be treated as fiscally transparent for German tax purposes if it resembles a German partnership, although it might have elected to be treated as a non-transparent corporation in the United States.<sup>333</sup>

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<sup>328</sup> See the different classification methods in chapter C section V in this study; see also Frotscher (note 4) 171; An exception constitutes the Swedish similarity approach, as it considers at least to some extent also foreign tax characteristics. See Barenfeld (note 27) chapter 8.

<sup>329</sup> See chapter C section V in this study.

<sup>330</sup> See chapter C section V in this study.

<sup>331</sup> Rijkele (note 137) Germany-Partnerships 5.6.3.6.; Barenfeld (note 27) 117

<sup>332</sup> Jacobs (note 164) chapter 4 A. I. 1. b.

<sup>333</sup> Gündisch (note 321) 425.

Besides, partnerships' treatment for tax purposes<sup>334</sup> also differs from country to country.<sup>335</sup> In this respect the OECD Partnership Report therefore indicates, that the term partnership does not imply anything about its tax treatment.<sup>336</sup> Some countries treat partnerships generally and irrespective of any election as corporation for tax purposes and insofar different from many other countries.<sup>337</sup> This potentially results in a conflict of qualification even if the entity is consistently classified as partnership in both countries.<sup>338</sup>

As the South American 'sociedad colectivas' (general partnership) and the 'sociedad en comanditas' (limited partnership), for instance, resemble the German partnership types, they are treated as fiscally transparent for German tax purposes, irrespective of their treatment as non-transparent corporations under the Chilean tax regime.<sup>339</sup>

In short, a qualification conflict concerning the subject of taxation occurs when the same entity is treated as non-transparent in one country and transparent in the other country.<sup>340</sup> Facilitated is such a conflict, either if the same entity is classified differently or despite common classification treated differently for tax purposes in two or more countries. Contrary to corporations which are legally and fiscally treated more or less in the same manner by most of the countries, partnerships are not subject to such a consistent transnational concept.<sup>341</sup> As indicated, their tax classification and their tax treatment vary considerably between countries' jurisdictions, and countries are insofar not obliged to follow the tax concept applied in the other contracting country.<sup>342</sup>

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<sup>334</sup> Like its general law nature.

<sup>335</sup> See chapter C section III in this study.

<sup>336</sup> OECD Partnership Report (note 1) Introduction 7.

<sup>337</sup> Examples: sociedad colectiva (general partnership) and sociedad en comandita (limited partnership) according to the domestic tax law of Bolivia, Brazil, Chile, Colombia, Mexico, Spain. See Jacobs (note 164) chapter 4 A. I. 1. b.; see also footnote 193.

<sup>338</sup> Frotscher (note 4) 170; Brincker (note 154) 552.

<sup>339</sup> Jacobs (note 164) chapter 4 A. I. 1. b..

<sup>340</sup> Frotscher (note 4) 170. Also referred to as 'asymmetrical situation'. See Barenfeld (note 27) 3.

<sup>341</sup> Barenfeld (note 27) 3. In contrast to homogeneous companies (corporations) the partnership constitutes a heterogeneous business vehicle.

<sup>342</sup> Gündisch (note 321) 425; Frotscher (note 4) 171; Müller and Wangler (note 250) 145-146.

Therefore, partnerships are particularly vulnerable to the above form of qualification conflicts.<sup>343</sup>

#### **D. Taxation of cross-border partnerships, a German perspective**

The following chapter deals with the various effects of a qualification conflict on the taxation of cross-border partnerships. In order to understand the specific tax issues involved it is necessary to give a short overview of the general taxing principles and provisions applied in cross-border situations. In section I it is therefore dealt with the general concepts in international taxation. Reference is insofar given to the specific German tax provisions dealing with these international tax concepts.

The taxing principles with regard to the taxation of cross-border partnerships and the effects of qualification conflicts in this respect are subject to analysis in part II. The analysis is insofar based on two fixed scenarios, the 'Outbound' and the 'Inbound' investment of a partner. Germany is in both basic constellations involved, either as country, where the partnership has its legal seat or place of effective management ('partnership country'<sup>344</sup>), or as country, where the partner of the partnership resides ('partner country'<sup>345</sup>). In order to reveal the actual tax effects of qualification conflicts, the fixed scenarios first deal with the general taxation of cross-border partnerships without qualification conflict and then proceed to address the taxation when a qualification conflict occurs. It is insofar also dealt with the different approaches aiming at solving the qualification conflict and its adverse tax effects. Focus are however the approaches developed by the OECD, their effectiveness and how they are followed by German tax authorities, legal scholars and jurisdiction.

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<sup>343</sup> Müller and Wangler (note 250) 145-146; Gummert and Weipert (note 326) §58 Ertragsteuern margin number 494; Barenfeld (note 27) 117.

<sup>344</sup> The country where the partnership has its legal seat or place of effective management is hereinafter referred to as 'partnership country'.

<sup>345</sup> The country where the partner of the partnership resides is hereinafter referred to as 'partner country'.

## I. General concepts in cross-border tax situations

### 1. Double Taxation

The term double taxation already implies that 'the same income is taxed more than once'.<sup>346</sup> Insofar two different types of double taxation, however, can be distinguished.<sup>347</sup>

Juridical double taxation generally refers to the situation where the same taxpayer is subject to comparable tax on the same income for identical periods in two or more states.<sup>348</sup>

This type of double taxation is of international nature only and due to the countries' overlapping principles of taxation in a cross-border situation.<sup>349</sup> Insofar the principles of residence and the principle of source are of significance and applied by countries to justify their tax claims against domestic and foreign taxpayers.<sup>350</sup> A person is generally subject to unlimited tax liability on his worldwide income in his country of residence.<sup>351</sup> Worldwide income means insofar that the tax liability is not confined to the income produced in the domestic market but covers income produced all over the world regardless of its specific source.<sup>352</sup>

In Germany this principle is applied by s 1 (1) of the Income Tax Act for individuals and s 1 (1) Corporate Tax Act for corporations. Section 1 (1) of the Income Tax Act provides for unlimited tax liability of individuals if their residence or normal place of abode is within the German territory.<sup>353</sup> Corporations must have their seat or effective place of management<sup>354</sup> in Germany in order to become subject to

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<sup>346</sup> Barenfeld (note 27) 84.

<sup>347</sup> Frotscher (note 4) 4-5.

<sup>348</sup> Frotscher (note 4) 4.

<sup>349</sup> Barenfeld (note 27) 84-85.

<sup>350</sup> Frotscher (note 4) 7.

<sup>351</sup> Jacobs (note 164) part 4 chapter 1 B. II. 1. (a) (1). Also referred to as the 'worldwide income principle'. This taxing principle can be distinguished from the principle of citizenship. According to that a person is liable to tax on his worldwide income due to his citizenship in a country and irrespective of its place of residence. This approach is applied by the USA. See Barenfeld (note 27) 85

<sup>352</sup> Frotscher (note 4) 7.

<sup>353</sup> Section 8 and 9 Internal Revenue Code.

<sup>354</sup> Section 10 and 11 Internal Revenue Code.

unlimited tax liability.<sup>355</sup> Apart from other special provisions<sup>356</sup> these are in Germany the main justifications for the taxation of a person's worldwide income.

The principle of source on the other hand confines a country's taxing rights on income produced within its territory yet regardless of where the person who generates this income resides.<sup>357</sup> In Germany this is provided by s 1 (4) in conjunction with s 49 (1) of the Income Tax Act according to which foreign<sup>358</sup> individuals are subject to limited tax liability on income received from sources within the German territory, specifically enumerated in s 49 (1).<sup>359</sup> These sources feature a 'genuine link' to the German territory which aim at justifying the taxation of these sources as domestic source income.<sup>360</sup> Such a link, for instance, exists if a foreign individual receives income attributable to a German permanent establishment.<sup>361</sup> According to s 2 No.1 Corporate Tax Act foreign<sup>362</sup> corporations are equally subject to limited tax liability in Germany if they, like individuals derive income from a German source enumerated in s 49 (1) Income Tax Act.

Like Germany, countries do not confine their taxing rights to one principle of taxation, but usually pursue the principle of source and the principle of residence together in order to secure its tax revenue.<sup>363</sup> This may in a cross border situation, however, result in overlapping taxing rights of two or more countries and thus in the above issue of juridical double taxation.

For example an individual resident in a foreign country and receiving income from a German permanent establishment may be subject to limited tax liability in Germany due his source of income and, provided the foreign country pursues the above

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<sup>355</sup> Section 1 (1) Corporate Tax Act.

<sup>356</sup> Like s 1 (2), (3) or s 1 (a) of the Income Tax Act.

<sup>357</sup> Barenfeld (note 27) 85.

<sup>358</sup> If neither their residence nor their normal place of abode is in Germany. See s 1 (4) of the Income Tax Act.

<sup>359</sup> Section 2 of the German Foreign Tax Relations Act (in Germany referred to as 'Außensteuergesetz') is another more specific provision aiming at extending the tax liability for domestic source income.

<sup>360</sup> Frotscher (note 4) 110.

<sup>361</sup> See s 49 (1) No.2 (a) Income Tax Act. Referred to as concept of 'permanent establishment'. See Frotscher (note 4) 242. This concept is also applied to cross-border partnerships. See insofar chapter D in this study.

<sup>362</sup> If neither their domestic seat nor their effective place of management is situated in Germany. See s 2 (1) of the Corporate Tax Act.

<sup>363</sup> Lynette Olivier 'Residence based taxation' (2001) *TSAR* 20 at 21; Barenfeld (note 27) 85.

principles<sup>364</sup>, due to his residence additionally subject to unlimited tax liability on the same income in the foreign country.

As the principles themselves also vary in detail from country to country the same person may even be considered a resident and subject to unlimited taxation in both countries.

In all these instances, international juridical double taxation occurs. The person is subject to a more burdensome taxation than what is intended from a domestic perspective<sup>365</sup>.

Economic double taxation, as already indicated above, may be of domestic or international nature and may particularly in the countries' domestic tax systems even be intentionally adopted, for example, in context of the taxation of corporations and their respective shareholders (double-tax pattern).<sup>366</sup> A corporation is insofar subject to some sort of corporate tax and the shareholder additionally subject to tax upon distribution of the companies' profits. Countries adopt specific tax systems in order to relieve the taxpayers from this sort of double taxation. Considering the example of corporations, economic double taxation, however, means that two different persons are subject to tax<sup>367</sup> which also constitutes the main difference to juridical double taxation.<sup>368</sup>

Apart from the example of a domestic corporation and its domestic shareholder economic double taxation could equally occur in a cross-border situation, where a foreign shareholder invests in a domestic corporation or conversely.<sup>369</sup> This situation might become even more complex, if the countries classify the entity differently as

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<sup>364</sup> South Africa, for instance, used to tax income according to the source principle only. However, it amended its Tax Act in this respect and adopted a residence principle in order to tax South African residents on their worldwide income. Besides, non-residents remain subject to tax on their South African source income. See Olivier (note 363) at 20.

Since 2001 residence and source principle are therefore also in South Africa applied equally and may accordingly lead to the issues, discussed above.

<sup>365</sup> Barenfeld (note 27) 102.

<sup>366</sup> See chapter C section IV in this study.

<sup>367</sup> In case of a corporation (or partnership treated as corporation), the entity itself is subject to corporate tax and the shareholder subject to tax upon distribution.

<sup>368</sup> Frotscher (note 4) 4-6.

<sup>369</sup> Barenfeld (note 27) 86.

non-transparent subject to the double-tax pattern in one country and as fiscally transparent partnership subject to the single-tax pattern in the other country.<sup>370</sup>

## 2. Double tax relief

A country extending its taxing rights to the worldwide income of a person goes beyond its territory and constitutes therefore the main reason for international juridical double taxation, as its tax claim basically facilitates the overlapping of taxing rights.<sup>371</sup> Accordingly it is normally upon the country of residence to relieve the taxpayer from double taxation in a cross-border situation.<sup>372</sup> Countries have adopted different unilateral rules in their domestic tax systems.<sup>373</sup> Additionally countries agreed on bilateral<sup>374</sup> rules according to different DTCs entered into with other countries.<sup>375</sup>

Whether unilaterally or bilaterally adopted, one can generally distinguish between three main means to relief income from juridical double taxation.

One of these means constitutes the exemption method, which assigns the taxing rights to one country exclusively<sup>376</sup>, by exempting the income in the other country<sup>377</sup> from tax.<sup>378</sup> Some countries, however, include the exempted income in the tax base in order to consider it when computing the tax rate in their progressive tax system.<sup>379</sup>

According to the credit method both, the country of residence and the country of source include the same income of the respective taxpayer in its tax base in order to compute its tax rate.<sup>380</sup> However, usually by the residence country, the taxpayer is subsequently granted a `credit for the tax paid in the source country against the

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<sup>370</sup> See in this study chapter D section II.

<sup>371</sup> Frotscher (note 4) 7. If all countries would only pursue the source principle an overlapping of taxing right was impossible. International juridical double taxation would then not occur.

<sup>372</sup> Jakob (note 148) 394.

<sup>373</sup> See s 34 Income Tax Act. See for details footnote 384.

<sup>374</sup> For examples of multilateral DTCs see para 37-40 of the introduction to the OECD MTC.

<sup>375</sup> Frotscher (note 4) 8.

<sup>376</sup> Typically the country of source.

<sup>377</sup> Usually the country of residence.

<sup>378</sup> Jakob (note 148) 403

<sup>379</sup> See art 23 A (3) OECD MTC; Art 23 para 14 of the Commentaries on the OECD MTC. Also referred to as `exemption with progression`.

<sup>380</sup> Jakob (note 148) 403.



domestic tax<sup>381</sup>. Insofar some countries adopt a method which confines the credit to the tax paid in the domestic country and denies a credit for the foreign tax amount exceeding the domestic tax amount allocable to the foreign income.<sup>382</sup>

The deduction method, finally, allows the taxpayer to deduct the tax amount paid in the foreign country from its domestic tax base like deductible expenses.<sup>383</sup>

As indicated in the introduction, this study is confined to bilateral methods for the relief of double taxation, ie to the provisions of the OECD MTC.<sup>384</sup>

Germany has negotiated about 90 DTCs<sup>385</sup> aiming at the elimination of international double taxation of income or gains<sup>386</sup> arising in one territory and paid to residents of another territory.<sup>387</sup> DTCs are international contracts between two or more countries, which become in Germany applicable domestic law by approval according to art 59 (2) of the German Constitution.<sup>388</sup> These international contracts are to be regarded as 'lex specialis', prevailing over the more general domestic tax provisions<sup>389</sup>, as indicated by s 2 Internal Revenue Code and resulting from the common rules for the

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<sup>381</sup> Barenfeld (note 27) 87.

<sup>382</sup> Barenfeld (note 27) 87. Also referred to as 'ordinary credit method' in contrast to a 'full credit method' according to which the amount exceeding the domestic tax amount is equally creditable.

<sup>383</sup> Rijkele (note 137) Germany-Partnerships 5.6.3.5.3..

Adopted in Germany unilaterally. However, not dealt with in the OECD MTC.

<sup>384</sup> Unilaterally the exemption method is not available in Germany. Instead the credit method constitutes the main method to relieve resident taxpayers from double taxation. According to s 34 c of the Income Tax Act<sup>384</sup> a resident taxpayer, subject to unlimited tax liability in Germany, who is also subject to comparable tax in a foreign country on income originating in that country, is allowed to credit the paid foreign tax against the domestic tax going on the income of that country. In short, 'the amount of creditable foreign tax is limited to the amount of domestic tax allocable to the foreign-source income'<sup>384</sup> and denied as far as the levied foreign tax exceeds the domestic tax amount.<sup>384</sup>

Furthermore, the taxpayer is only eligible of taking advantage of the credit if he produces income in terms of s 34 d Income Tax Act. However, the credit method is not applicable, if the income is derived by a corporation from a foreign corporation. Section 8 b Corporate Tax Act then exempts 95% of the dividend income from tax. This is in Germany, nevertheless, not regarded as exemption method in the above sense. As an alternative to the above credit method the taxpayer may also choose the deduction method as means to eliminate the double taxation of his income.<sup>384</sup> According to s 34 c (2) and (3) Income Tax Act<sup>384</sup> the taxpayer is on request or upon presence of specific circumstances allowed to deduct the foreign taxes from its German tax base in order to reduce its domestic tax rate, and thereby compensating the double taxation. See Frotscher (note 4) 85-100.

<sup>385</sup> Frotscher (note 4) 22.

<sup>386</sup> Capital gains are not dealt with in this study.

<sup>387</sup> Para 1-3 of the introduction to the OECD MTC.

<sup>388</sup> Frotscher (note 4) 24.

<sup>389</sup> Jakob (note 148) 399.

application of tax laws.<sup>390</sup> Existing DTCs therefore to a great extent replace the domestic relief method.<sup>391</sup>

The following structure of the OECD MTC aims at giving a short overview of tax treaties following the Model Tax Convention. The structure is accordingly limited to its main provisions. It may be regarded as the basic order of examination when applying a DTC to a cross-border situation and is in a modified form also used for the second section of this chapter.

### **a) Factual and personal scope of the OECD MTC**

According to art 1 of the MTC the Convention covers income and capital gains tax levied by the Contracting countries (factual scope).<sup>392</sup>

Article 1, 3 and 4 regulate the entitlement to the Convention (personal scope).<sup>393</sup> According to art 1 the Convention applies to persons resident in at least one of the contracting countries. The entitlement to the Convention benefits depends accordingly on whether the taxpayer is a person in terms of art 3 (1) (a) and whether he can be regarded as a resident according to art 4.

### **b) Distributive rules and methods for elimination of double taxation**

It has to be considered that DTCs are not able to establish taxing rights in favor of the contracting countries.<sup>394</sup> The determination of the taxability of the income takes place under the domestic law of these countries prior to any consideration of a DTC and follows the international tax principles set out above.<sup>395</sup> The DTC, if negotiated between the countries, may only apply subsequently to distribute or restrict these taxing rights already established and claimed by each country under their domestic tax law.<sup>396</sup>

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<sup>390</sup> Frotscher (note 4) 26. Principle of 'lex specialis derogat legi generali'.

<sup>391</sup> See s 34 c (6) Income Tax Act. For the domestic credit method in Germany see footnote 384.

<sup>392</sup> Jakob (note 148) 401.

<sup>393</sup> Jakob (note 148) 401; Frotscher (note 4) 111.

<sup>394</sup> Frotscher (note 4) 100.

<sup>395</sup> Jakob (note 148) 401. See in this study chapter D section I 1. for the principles of taxation.

<sup>396</sup> Jakob (note 148) 401.

To what extent the countries' rights to tax are maintainable or to be limited is dependent on the type of income and insofar determined by the main part of the OECD MTC.<sup>397</sup> With respect to each type of income it is distinguished between the resident state and the source state.<sup>398</sup> Resident state is generally the state where the taxpayer who derives income from a foreign State resides and source state refers to the state where the taxpayer produces the income subject to tax in that state.<sup>399</sup>

Articles 6-22 aim at arranging the taxing rights of these states with regard to income<sup>400</sup> or capital. These distributive rules mainly address the taxation in the source state and may, depending on the applicable provisions, result in the source state's taxing right being maintained<sup>401</sup>, being restricted<sup>402</sup>, being precluded<sup>403</sup> or being limited to a certain amount<sup>404</sup>.<sup>405</sup> Where the taxing rights of both states maintain to a certain extent after application of the distributive rules, the provisions refer to art 23 in order to eliminate the then existent double taxation of the same income.<sup>406</sup> Insofar it is upon the residence state of the taxpayer to apply art 23.<sup>407</sup> There is, however, no need to apply Art 23, where the distributive rules confer the right to tax on one of the contracting countries only and therewith avoid double taxation without application of any further articles.<sup>408</sup>

According to art 6, for example, income from immovable property situated in one Contracting State and derived from a resident in the other Contracting State may also be taxed by the first State. Insofar both, the country of source and the country of

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<sup>397</sup> Alexander Rust 'The New Approach to Qualification Conflicts has its Limits' (2003) Bulletin-Tax Monitor 45 at 45 and 46.

<sup>398</sup> Debatin (note 321) at 1181.

<sup>399</sup> Debatin (note 321) at 1181; see also art 4 of the OECD MTC.

<sup>400</sup> See art 6-21 of the OECD MTC. The following in this study refers to income only.

<sup>401</sup> For instance Art 6 OECD MTC, according to which income from immovable property may be taxed in the source state without any restriction.

<sup>402</sup> For instance Art 7 OECD MTC, according to which the source state may only tax the income attributable to a permanent establishment situated in its state.

<sup>403</sup> According to Art 21 only the residence state is allowed to tax other income.

<sup>404</sup> For instance dividends according to Art 10, which provides that the source state must limit its taxation to a certain amount.

<sup>405</sup> See para. 21-4 of the introduction to the OECD MTC; Debatin (note 321) 1181.

<sup>406</sup> See para. 25 of the introduction to the OECD MTC. Referred to as 'open distributive rules', which have to be read with Art 23 OECD MTC. Rust (note 397) at 46.

<sup>407</sup> Para. 25 of the introduction to the OECD MTC; see also wording of Art 23 A and B of the OECD MTC; Rust (note 397) at 46.

<sup>408</sup> Para. 24 of the introduction to the OECD MTC. Referred to as 'complete distributive rules'. See Rust (note 397) 47.

residence are allowed to tax the income which may only be avoided by application of art 23 A or B.<sup>409</sup>

According to art 7, on the other hand, business profits of an enterprise of a contracting state are taxable 'only' in that state, unless the same enterprise carries on its business through a permanent establishment in the other contracting state. Provided there is no permanent establishment in the source state, the right to tax is exclusively conferred on the residence state of the enterprise. By the term 'only' it is implied that the source State has to waive its right to tax.<sup>410</sup> Double taxation is therefore avoided without further reference to Art 23 A or B.<sup>411</sup>

As indicated above, article 23 comes into operation where art 6-22 maintain the right to tax in both contracting states. Article 23 is addressed to the state of residence and provides for two different methods aiming at the elimination of double taxation.<sup>412</sup>

According to art 23 A (1) of the OECD MTC the income may be relieved from double taxation by being completely exempted from tax in the state of residence.<sup>413</sup>

The resident State may however consider the exempted income and include it in the taxpayer's tax base when calculating and determining the tax amount on the remaining domestic income which usually leads to a higher tax rate in a progressive tax system.<sup>414</sup> As regards Germany, this concept is introduced in its domestic tax law by s 32b (1) No 3 of the Income Tax Act.<sup>415</sup>

Alternatively the state of residence may allow a credit amounting to the tax paid in the State of source, stipulated in art 23 B of the OECD MTC.<sup>416</sup> Many negotiated DTCs do not contain any rules regarding the implementation of this rule and refer therefore in this respect to the relevant domestic rules.<sup>417</sup> In Germany this is carried

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<sup>409</sup> Frotscher (note 4) 116.

<sup>410</sup> Frotscher (note 4) 116.

<sup>411</sup> Jakob (note 148) 402.

<sup>412</sup> Para. 25 of the introduction to the OECD MTC; Rust (note 397) 46.

<sup>413</sup> Para. 25 of the introduction to the OECD MTC. Referred to as 'Exemption method'.

<sup>414</sup> See art 23 A (3) OECD MTC; Art 23 para. 14 of the Commentaries on the OECD MTC. Also referred to as 'exemption with progression'.

<sup>415</sup> Frotscher (note 4) 89.

<sup>416</sup> Para. 25 of the introduction to the OECD MTC. Referred to as 'Credit method'.

<sup>417</sup> Frotscher (note 4) 96.

out by s 34 c (6) sentence 2 of the Income Tax Act, which renders its implementation rules applicable as far as the credit method of a German DTC is concerned.<sup>418</sup>

As indicated by the OECD Commentary, Art 23 is generally based on the concept of juridical double taxation.<sup>419</sup> In the examples discussed in part II however double taxation does not completely comply with this concept due to the conflict of qualification between the contracting countries.<sup>420</sup> To be clarified is insofar whether Art 23 nevertheless applies in these situations.

## II. Taxation of cross-border partnerships

As it was shown in the previous chapter, partnerships' classification, as well as their treatment for tax purposes, vary considerably between countries' jurisdictions. Due to their heterogeneity partnerships are therefore particularly vulnerable to conflicts regarding their qualification for tax purposes.

The different effects of this conflict with regard to cross-border partnerships are subject to examination in this part of the study. As will be illustrated on the basis of certain examples the different classification and tax treatment of the partnership in the partner country, the partnership country and the country where the source is situated ('source country')<sup>421</sup> may easily lead to double taxation.<sup>422</sup> However questionable is, whether the application of the OECD MTC succeeds in relieving these situations from that excessive taxation. Of particular relevance are in this context the entitlement of partnerships to the benefits of the OECD MTC and the availability of its tax relief rules, both in case of a conflict of qualification between the contracting states.

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<sup>418</sup> Frotscher (note 4) 96.

<sup>419</sup> Art 23 A and B para. 1-2 of the Commentary on the OECD MTC; for the definition of the term 'juridical double taxation' see in this study chapter D section I 1.

<sup>420</sup> See in this study chapter D section II 1. b) bb) (2) (2.1).

<sup>421</sup> If different from the partner country or the partnership country. Hereinafter referred to as the source country. In the analyzed examples the source is situated in the partnership country.

<sup>422</sup> Frotscher (note 4) 170.

In order to keep the study in a structured manner, it is carried out by way of certain examples which aim at identifying and elaborating the main problems concerning cross-border partnerships and the conflicts relating to their classification for tax purposes.

The examples aim at illustrating the taxation of cross border partnerships as it would be without any qualification conflict. Subsequently, the same examples are used to demonstrate how the usual taxation is effected by the occurrence of a qualification conflict between the respective countries.

Generally, endless different tax situations and issues are conceivable with respect to partnerships operating cross-border.<sup>423</sup> The analysis is therefore confined to fixed scenarios where certain tax features are assumed in order to direct the focus onto the main tax issues relating to qualification conflicts. The following basic conflicts can in general be distinguished<sup>424</sup>:

1. A partnership is regarded as non-transparent in the partnership country, but classified as transparent in the partner country.
2. In the partnership country the partnership is classified as transparent, however, it is regarded as non-transparent in the partner country.

The examples, used for the analysis at hand, are accordingly divided into two main situations, namely the 'Outbound' and the 'Inbound' investment by a partner. In the first situation a partner, resident in Germany (partner country), invests in a partnership organized in a foreign country (partnership country). The latter situation, on the contrary, refers to a partner, who is resident in a foreign country (partner country) and investing in a partnership organized in Germany (partnership country). In both cases the partnership is carrying out a business<sup>425</sup> through a permanent establishment in its state of organization. The income in question is in both situations attributable to the permanent establishment.

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<sup>423</sup> Especially if a third country is involved ('triangular situation').

<sup>424</sup> Barenfeld (note 27) 130; Daniels (127) 54.

<sup>425</sup> As indicated above under chapter C section III 2. a partnership may at least according to German tax law also carry out other activities. However, for the purposes of this study it is assumed that the partnership carries out a business.

It is assumed that the contracting countries entered into a DTC, based on the provisions of the OECD MTC.

As indicated, a DTC cannot establish taxing rights in favor of the contracting countries. As the countries' domestic tax law is not subject to examination in this study, these domestically established taxing rights regarding the income of the partnership are assumed and based on either the source principle or the residence principle, depending on the facts of each case and on the country claiming the right to tax.<sup>426</sup>

The different tax issues are dealt with from a German perspective. Its classification and tax treatment of domestic and foreign partnerships and their partners constitutes therefore a point of departure in the examples.

As discussed in the previous part, Germany considers domestic partnerships as transparent for tax purposes.

With respect to entities organized in a foreign country, Germany applies the similarity approach in order to determine whether the foreign entity can be regarded as a fiscally transparent partnership or as a non-transparent corporation for domestic tax purposes. It is insofar assumed that Germany classifies the foreign entity as a fiscally transparent partnership, irrespective of its tax treatment in the foreign country.

The foreign country treats its domestic and the German partnership either the same way<sup>427</sup> as Germany or differently<sup>428</sup> for domestic tax purposes.

By taking into account these assumptions, the following situations are analyzed.

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<sup>426</sup> For the principles see in this study chapter D section I.

<sup>427</sup> See in this study chapter D section II 1. a) and 2. a).

<sup>428</sup> See in this study chapter D section II 1. b) and 2. b).

## 1. German partner/foreign partnership ('Outbound')

An individual<sup>429</sup> is resident in Germany and derives as partner (P) income from a foreign partnership (PS). The partnership carries on business through a permanent establishment (PE), situated in the foreign partnership country.

### a) Taxation if both countries apply the transparency approach

In general, when analyzing the taxation of cross-border partnerships it must be distinguished between the situation in the partnership country and the situation in the partner country.

#### aa) Taxation in the foreign partnership country (source country<sup>430</sup>)

##### (1) Entitlement to the Convention benefits

Bilateral tax treaties only 'apply to *persons* who are *resident* in one or both of the contracting states.'<sup>431</sup> Considering that provision as a point of departure, it has to be examined whether the foreign partnership fulfills these requirements and may as such be entitled to the benefits of the Convention.

Article 3(a) of the OECD MTC defines the term 'person' as including an individual, a company and any other body of persons. According to the OECD Partnership Report and the amended Commentary a partnership is to be regarded as a person under the Convention either because it is covered by the definition of a company or because it constitutes a body of persons.<sup>432</sup> Companies are insofar to be regarded as juridical persons or any other entity treated as juridical person for tax purposes<sup>433</sup>. Under the transparency approach a partnership is considered fiscally transparent and

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<sup>429</sup> Imaginable is also a corporation as partner of a partnership. The additional analysis of such situations would make the study, however too extensive. Therefore the analysis is confined to individuals as partners.

<sup>430</sup> The partnership country also constitutes the source country, as the income is attributable to a permanent establishment situated therein.

<sup>431</sup> See Art 1 of the OECD MTC.

<sup>432</sup> OECD Partnership Report (note 1) 12; art 3 para 2 of the OECD Commentary on the OECD MTC; see also Michael Lang (note 47) 31-32.

<sup>433</sup> Article 3(1)(b) OECD MTC.



therefore not covered by this definition for the purpose of the convention.<sup>434</sup> However, irrespective of the partnership's treatment for tax purposes in the respective states, it is at least to be regarded as a body of persons and hence as a person in terms of the Convention.<sup>435</sup>

However, in order to qualify as a person covered by the Convention a partnership must also qualify as a resident of one or both of the contracting states.<sup>436</sup>

According to art 4 the term resident is defined as:

'...any person who, under the laws of that State, is liable to tax therein by reason of his domicile, place of management or any other criterion of similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.'

A partnership may therefore be regarded as a resident if it is liable to tax by reason of its domicile, place of management or any other criterion of a similar nature in at least one of the contracting States. It should accordingly be subject to unlimited tax liability according to the worldwide income principle.<sup>437</sup>

As discussed above some countries treat partnership as corporations, subject to tax as such. Insofar the partnership qualifies as a resident in the country of its seat or place of effective management, as it is subject to unlimited taxation on its worldwide income therein.<sup>438</sup>

Other countries, on the contrary, treat partnerships as fiscally transparent and tax only the partners on their share of the partnership income.<sup>439</sup> According to the tax laws of these countries partnerships are not liable to tax as such and therefore not resident in terms of art 4.<sup>440</sup> Instead, the partners are liable to unlimited taxation due to their residence and can accordingly resident for Convention purposes.<sup>441</sup>

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<sup>434</sup> Frotscher (note 4) 177; Daniels (note 127) 142.

<sup>435</sup> Barenfeld (note 27) 151.

<sup>436</sup> Frotscher (note 4) 178.

<sup>437</sup> Jakob (note 148) 401.

<sup>438</sup> Frotscher (note 4) 178.

<sup>439</sup> Like Germany, for example.

<sup>440</sup> Debatin (note 321) 1183.

<sup>441</sup> Debatin (note 321) 1183.

Whether or not a partnership is liable to tax and therewith resident in the sense of art 4, depends therefore on its treatment for tax purposes.<sup>442</sup> This is also confirmed by the Commentary to the OECD MTC as result of the OECD Partnership Report.<sup>443</sup> As the above interpretation is directly based on the wording of art 4 of the Convention it was, however, already commonly accepted prior to the OECD Partnership Report and its incorporation into the commentary.<sup>444</sup>

The OECD nevertheless adds to the above interpretation by dealing with the term 'liable to tax' and how this term is supposed to be understood considering the different approaches in the countries' tax systems.<sup>445</sup> In this respect the CFA recognizes the problem of intermediary situations where a partnership is partly regarded as transparent and partly treated as non-transparent for tax purposes.<sup>446</sup> It decided, however, to deal with this issue within the follow-up work to the report.<sup>447</sup> Furthermore, and more interesting for the purpose of this study, the Committee dealt with the entity approach discussed above<sup>448</sup> and examined how the term 'liable to tax' should be understood in this context.<sup>449</sup> According to the entity approach pursued by Germany the partnership is basically regarded as fiscally transparent but treated as a distinct taxpayer for the purpose of computing the income at its level, before allocated and taxed in the hands of the partners. In other systems even the final assessment of the tax is done at the partnership level.<sup>450</sup> However, according to the CFA, the decisive question is whether the tax amount payable on the partnership's income is determined by the characteristics of the partnership itself or the personal characteristics of the partners. In the latter case, as applied in Germany, the partnership is not liable to tax irrespective of the fact that the income is computed

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<sup>442</sup> Rijkele (note 137) Germany-Partnerships 5.6.7.1.; Frotscher (note 4) 178.

<sup>443</sup> Art 1 para. 5 and Art 4 para. 8.7 of the Commentary on the OECD MTC

<sup>444</sup> Michael Lang (note 47) 35.

<sup>445</sup> OECD Partnership Report (note 1) 14.

<sup>446</sup> OECD Partnership Report (note 1) 14.

<sup>447</sup> For an analysis of this issue see Barenfeld (note 27) 153-154.

<sup>448</sup> See chapter C section III 2. in this study.

<sup>449</sup> OECD Partnership Report (note 1) 14.

<sup>450</sup> OECD Partnership Report (note 1) 14.

at its level. Decisive in these situations is also, that it is in fact the legal obligation of the partner and not of the partnership to pay the taxes.<sup>451</sup>

As assumed above, both countries treat the partnership as transparent for tax purposes. Therefore the partnership is not subject to tax as such and accordingly not entitled to the Tax Treaty benefits. Instead, the partner is entitled to treaty benefits, provided he is a resident of one of the contracting states.<sup>452</sup>

## **(2) Taxation of the profits**

A DTC may not establish the countries' rights to tax the income.<sup>453</sup> The determination of the taxability of the income takes place under the domestic law of the contracting countries. For the purposes of this study it is however assumed that both countries have established those rights to tax the income domestically. The OECD MTC therefore applies to distribute or restrict these rights to tax already established.

That requires the allocation of the income, qualified under the countries' domestic law to the tax treaties' different income types.<sup>454</sup> The income qualification is to be applied by both States and is therefore to be examined separately.<sup>455</sup> Whether the partner of a partnership derives business income in terms of art 7 (1) of the OECD MTC or any other income, is generally determined by the law of the tax treaty.<sup>456</sup> However, since the Treaty refers to the countries' domestic law to a great extent<sup>457</sup>, the partner generally derives business income according to art 7, if the income was qualified the same way under the countries' domestic law.<sup>458</sup> Here it is assumed that the partnership is carrying on a trade or business.<sup>459</sup> The income is then to be qualified as business income according to the countries' domestic law.<sup>460</sup> The

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<sup>451</sup> Barenfeld (note 27) 157. This may also be helpful in cases where the tax is paid by the partnership, but on behalf of its partners.

<sup>452</sup> See German taxation chapter D section II 1.a) bb) (1).

<sup>453</sup> Frotscher (note 4) 100; see also chapter D section I 2.b) in this study.

<sup>454</sup> Jakob 401-402.

<sup>455</sup> Jakob 401-402.

<sup>456</sup> Müller and Wangler (note 250) 148.

<sup>457</sup> See art 3 (2) of the OECD MTC.

<sup>458</sup> Müller and Wangler (note 250) 148.

<sup>459</sup> In contrast to private investment, resulting in other domestic income types and equally in other income types under the Convention. See Müller and Wangler (note 250) 148.

<sup>460</sup> In Germany, the partner must also qualify as entrepreneur (Mitunternehmer) of the partnership in order to derive business income according to §15 (1) No 2. This is however assumed hereinafter.

partner's distributive share of the income of the foreign partnership falls therefore under art 7 (1).<sup>461</sup>

According to art 7 the concept of permanent establishment applies and decides as to the distribution of taxing rights between the countries.<sup>462</sup> The profits shall be taxable only in the State of the enterprise unless the enterprise carries on business through a permanent establishment in the other contracting State (state of source).<sup>463</sup> In case of a partner of a fiscally treated foreign partnership the business enterprise actually carried on by the partnership is regarded as being the one of the partner.<sup>464</sup> The partner's share therefore constitutes a business enterprise<sup>465</sup> in terms of art 7.<sup>466</sup> Accordingly, if the foreign partnership carries on its business activity through a permanent establishment, this establishment is directly attributable to the partner of the partnership.<sup>467</sup> Therefore, in order to determine whether the foreign country at hand has the right to tax the German partner's share of the profits, it has to be established whether the profits are attributable to a permanent establishment situated in the foreign country.<sup>468</sup> Insofar it has generally to be considered, that the mere investment by a partner in a foreign partnership does not in itself constitute a permanent establishment in the partnership country.<sup>469</sup> The term 'permanent establishment' is for these purposes defined in art 5 of the OECD MTC.<sup>470</sup> As assumed above, however, there is a permanent establishment situated in the foreign country. Moreover the profits are assumed to be attributable to this permanent establishment, as required by art 7 (1). Therefore the German partner can be considered to derive income attributable to a foreign permanent establishment and is accordingly subject to limited taxation in the foreign country on his share of the

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<sup>461</sup> Classified as 'business profits'. See Jacobs (note 164) part 4 chapter 4 B.I.2.a)(1); Frotscher (note 4) 181; Müller and Wangler (note 250) 148; Rijkele (note 137) Germany-Partnerships 5.6.7.2..

<sup>462</sup> Frotscher (note 4) 172.

<sup>463</sup> See art 7 (1) OECD MTC.

<sup>464</sup> Rijkele (note 137) Germany-Partnerships 5.6.7.2.; Debatin (note 321) 1183.

<sup>465</sup> See art 3 (1) d OECD MTC.

<sup>466</sup> Müller and Wangler (note 250) 148; Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1); Debatin (note 321) 1183.

<sup>467</sup> Frotscher (note 4) 172 and 242; Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>468</sup> See art 7 (1) of the OECD MTC.

<sup>469</sup> Rijkele (note 137) Germany-Partnerships 5.6.7.2..

<sup>470</sup> Debatin (note 321) 1184. A partnership's fixed place of business usually constitutes a permanent establishment for its foreign partner.

profits.<sup>471</sup> The foreign countries' domestic taxing right is insofar maintained by the OECD MTC.

## **bb) Taxation in Germany as partner country (residence country<sup>472</sup>)**

### **(1) Entitlement to the Convention benefits**

As Germany, like the foreign country, regards the partnership as transparent for tax purposes, the partnership is also from its perspective not a resident according to art 4 and therefore not entitled to the Convention benefits. Instead, the partner is resident<sup>473</sup> and subject to unlimited taxation in Germany<sup>474</sup>. The partner is accordingly entitled to the Convention benefits.<sup>475</sup>

### **(2) Taxation of the profits**

For the reasons indicated above, Germany also applies Art 7 regarding the partnership's profits.<sup>476</sup> According to Art 7 (1) Germany is entitled to tax the domestic partner's distributive share of the profits of the foreign partnership.<sup>477</sup> As indicated above, however, the Treaty also maintains the foreign country's right to tax the same share of the profits.<sup>478</sup> As a result the income is subject to double taxation, which is however eliminated by Germany, as residence country, usually by exempting the income from tax according to Art 23 A.<sup>479</sup> Germany may however consider the exempted income and include it in the taxpayer's tax base when calculating and determining the tax amount on the remaining domestic income.<sup>480</sup> This concept is introduced in Germany's domestic tax law by s 32b (1) No 3 of the

<sup>471</sup> See Art 7, 3 (1) (c) OECD MTC; Müller and Wangler (note 250) 149; IBFD 5.6.7.2.; Jacobs (note 164) part 4 chapter 4 B.II.2.a) (1); Rijkele (note 137) Germany-Partnerships 5.6.7.2..

<sup>472</sup> Under the present circumstances Germany constitutes the residence country of the partner, as the partner resides therein.

<sup>473</sup> Art 3 (1) (a), 4 (1) OECD MTC.

<sup>474</sup> Section 1 (1) Income Tax Act read with s 8 and s 9 Internal Revenue Code.

<sup>475</sup> Rijkele (note 137) Germany-Partnerships 5.6.7.1.; see also Art 1 para. 5 of the Commentary on the OECD MTC.

<sup>476</sup> See chapter D section II 1. a) aa) (2).

<sup>477</sup> Under German domestic law the German resident partner is subject to unlimited taxation on his worldwide income according to s 1 (1), s 15 (1) No 2 Income Tax Act in conjunction with s 8 and s 9 Internal Revenue Code.

<sup>478</sup> See art 7 (1) of the OECD MTC.

<sup>479</sup> Jacobs (note 164) part 4 chapter 4 B.II.2.a).

<sup>480</sup> See art 23 A (3) OECD MTC; Art 23 para 14 of the Commentaries on the OECD MTC.

Income Tax Act.<sup>481</sup> Alternatively the double taxation is eliminated by granting a credit for foreign tax, depending on the individual tax treaty design.<sup>482</sup>

**b. Germany applies the transparency-principle with regard to the foreign partnership however the foreign partnership country treats its domestic partnership as non-transparent for tax purposes (qualification conflict)**

**aa) Taxation in the foreign partnership country**

**(1) Entitlement to the Convention benefits**

Whether a partnership can claim Convention benefits depends on its treatment for tax purposes. Is a partnership treated as fiscally transparent, not the partnership itself, but its partners are entitled to Convention benefits, as they are the persons liable to tax. In contrast, if the partnership is regarded as non-transparent and liable to tax as such, the partnership itself is entitled to the Convention provisions. The Treaty benefits are accordingly allocated to the person who is liable to tax, whether it is the partnership itself, or the partner of the partnership. If the partnership is treated consistently by both Contracting states, this point leads not to further issues.<sup>483</sup>

However, entitlement to Convention benefits becomes an issue, if the countries, like the ones at hand, treat the partnership differently for tax purposes.

According to the German understanding the partnership is treated as fiscally transparent and therefore not a resident of the foreign country. Entitled to the Convention benefits are insofar only its partners regarded as resident taxpayer in Germany. In the foreign partnership country, however, the partnership is regarded as non-transparent and liable to unlimited taxation based on its legal seat or place of

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<sup>481</sup> Frotscher (note 4) 89.

<sup>482</sup> Rijkkele (note 137) Germany-Partnerships 5.6.7.2..

<sup>483</sup> See in this study chapter D section II 1. a).

effective management.<sup>484</sup> From the foreign country's perspective it is therefore a resident, entitled to the Convention benefits.<sup>485</sup>

Questionable is, however, how this conflict may be resolved for the purposes of the tax treaty.

The answer to this, in turn, depends on whose States' qualification is considered as being decisive regarding the entitlement to Convention benefits.

According to some scholars neither of the states' qualification is decisive.<sup>486</sup> Following the wording of art 3(2), which serves as a basic principle, the qualification of the entity is based on the law of the country applying the tax treaty.<sup>487</sup> As discussed earlier, unless the context requires otherwise, art 3 (2) refers to the meaning under the domestic laws of the states applying the convention, if the terms are not defined in the Convention itself.<sup>488</sup> Since the term partnership and its tax classification is not directly defined in the OECD MTC the contracting states may decide independently how they want to treat the partnership for tax purposes, by relying on their domestic understanding of the term.<sup>489</sup>

However, the OECD MTC generally aims at avoiding double taxation.<sup>490</sup> Yet, the above approach rather constitutes a main reason for the double taxation of partnership's income, as its reference to the countries' domestic law regularly results in conflicts of their qualification affecting the tax treaty application adversely. It can therefore not meet the overall purpose of the OECD MTC.<sup>491</sup> Furthermore, it enables the other contracting state to simply circumvent the partnership's entitlement to the tax treaty benefits in its home country, by simply referring to the transparency principle applied according to its domestic law.<sup>492</sup> Such an interpretation would,

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<sup>484</sup> Under domestic law usually subject to some sort of corporate tax. See chapter C section IV in this study.

<sup>485</sup> Art 4 OECD MTC. See also Art 1 para. 5 and Art 4 para. 8.7 of the Commentary on the OECD MTC.

<sup>486</sup> Wassermeyer 'Die Beurteilung der Abkommensberechtigung ausländischer Personengesellschaften durch Deutschland als dem Nichtansässigkeitsstaat der Personengesellschaft' (1998) *ISIR* 489 at 489.

<sup>487</sup> 'Lex fori interpretation'. See Daniels (note 127) 156.

<sup>488</sup> See chapter B section III in this study.

<sup>489</sup> Vogel (note 16) OECD-MA Art 3 margin number 98 and 99.

<sup>490</sup> See chapter B section II in this study; see also para 1-3 of the Introduction of the OECD MTC.

<sup>491</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 32.

<sup>492</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 32.

however, not comply with the object and purpose of the Treaty in terms of art 31 (1) VCLT.<sup>493</sup>

Moreover art 3 I b OECD MTC defines the term company as 'entity treated as body corporate for tax purposes', which applies at least to the contracting state treating the partnership like a non-transparent corporation and makes insofar any recourse to the domestic law of the states unnecessary.<sup>494</sup> The OECD MTC consequently defines the entitlement to treaty benefits itself and does not leave it to the classification of the contracting states.<sup>495</sup>

By considering the above arguments, the unrestricted interpretation according to the contracting states' domestic laws in terms of Art 3 (2) cannot be agreed with.

Lang nevertheless applies Art 3 (2).<sup>496</sup> He seems however to agree with the basic criticism above and interprets the provision therefore in a way that avoids reference to the countries' domestic law giving rise to qualification conflicts and undesirable double taxation. By considering the object of the treaty, ie to avoid double taxation, the phrase 'unless the context otherwise requires' shall in his opinion be interpreted as giving priority to the tax treaty's autonomous interpretation from its context. The term 'context' must be understood in a very broad sense, including the OECD MTC, its commentary and 'all historical, systematical and teleological aspects'. Reference to domestic law may only be made if the context does not provide for a reasonable result which is however rarely the case taking into account its broad meaning. Qualification conflicts and double taxation may therefore be avoided by interpreting art 3 (2) as giving priority to the interpretation according to the treaty's context. The term 'context' is commonly attributed a broad meaning.<sup>497</sup>

Questionable is, however, whether the wording of Art 3 (2) in fact supports the interpretation advocated by Lang. Insofar it is argued that the phrase 'unless the context requires otherwise' rather implies, that the term in question must be interpreted by the countries' domestic law first in order to determine whether the

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<sup>493</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 32. For details on 31 (1) VCLT see chapter B section II in this study.

<sup>494</sup> Jacobs (note 164) part 4 chapter 4 A I.2.b) (2); Frotscher (note 4) 179; Müller and Wangler (note 250) 147.

<sup>495</sup> Frotscher (note 4) 179.

<sup>496</sup> Michael Lang (note 105) at 608; Michael Lang (note 47) 21 - 27.

<sup>497</sup> See chapter B section III in this study.



context requires otherwise.<sup>498</sup> Both ways of interpretation according to the countries' domestic law and according to the context of the tax treaty are equally applicable.<sup>499</sup> The text of art 3 (2) gives no priority to the context. Which way of interpretation prevails is rather a question of the individual case.<sup>500</sup>

Considering these arguments Lang's approach appears not very reasonable. The wording of Art 3 (2) does not provide for any support in this respect. The fact that Lang's interpretation would serve the purpose of the treaty and may lead to desirable effects does insofar not provide for a valid argument, as the clear wording of the treaty prevails.<sup>501</sup>

A different approach is advocated by the OECD CFA in its partnership report, which aims at dealing with qualification conflicts and solving this issue by reference to different cross-border partnership examples.<sup>502</sup> The main principles are now incorporated in the commentary to the OECD MTC, which states with regard to the present problem as follows:

‘...the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. If that State ‘flows through’ the income to the partner, then the partner should be considered liable to tax and entitled to the benefits of the Convention of the State of which he is resident.’<sup>503</sup>

The State of source should accordingly take into consideration and follow the partnership's treatment in the State where the person claiming treaty benefits is resident. In case of a qualification conflict the contracting countries may therefore deviate from the interpretation based on art 3 (2).<sup>504</sup> Instead of referring to the contracting states' domestic law, the tax treatment of the partnership in the residence country shall be relevant also for the source country.

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<sup>498</sup> Barenfeld (27) 172.

<sup>499</sup> Vogel (note 16) OECD-MA Art 3 margin number 119.

<sup>500</sup> Vogel (note 16) OECD-MA Art 3 margin number 119.

<sup>501</sup> The purpose of the treaty constitutes only secondary means of interpretation according to the VCLT. See chapter B section II in this study.

<sup>502</sup> See OECD Partnership Report (note 1) 21.

<sup>503</sup> Art 1 para. 6.3 of the Commentaries on the OECD MTC.

<sup>504</sup> OECD Partnership Report (note 1) para. 62.

This approach may lead to a reasonable result in the following constellation: The source of income is situated in a country which considers the foreign partner as liable to tax and entitles him to the benefits of the tax treaty. The partnership and the partner, however, reside in the other contracting State, which treats the partnership as liable to tax as such and entitled to the Convention benefits.<sup>505</sup>

Applying the principle developed by the OECD CFA to this example, the State of source considers and follows the partnership's tax treatment in the state of residence and accordingly provides for the partnership's entitlement to the treaty benefits in both contracting States. That the source country follows the approach advocated by the OECD and accepts the treatment in the resident State, is in this case very likely, as the tax treatment relates to a foreign entity from its perspective.<sup>506</sup> The OECD concept may accordingly avoid qualification conflicts in these situations and may therefore result in symmetry as to the entitlement to Convention benefits.

However, the facts of the example at hand are different. The partnership country constitutes the residence country regarding the partnership and equally the source country, considering the permanent establishment situated therein. It treats the partnership as resident and entitled to the benefits of the OECD MTC. Germany, on the other hand, regards its partner as resident in Germany and entitled to the Convention benefits, by treating the partnership as fiscally transparent.

In the present case therefore both, the partnership country and the German partner country constitute the state of residence for either the partnership or the partner.<sup>507</sup> Germany as residence country of the partner can therefore not be obliged to consider the partnership's tax treatment in the partnership country. Based on the wording of the OECD approach, the partnership country, however, would besides its residence status be forced to ignore 'its own tax treatment of a domestic business vehicle' as it equally constitutes the source country.<sup>508</sup> It would accordingly have to follow the tax treatment in the German partner country.<sup>509</sup> However, it is not very likely that the partnership country disregards its own classification rules regarding its domestic

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<sup>505</sup> Barenfeld (note 27) 166.

<sup>506</sup> Barenfeld (27) 166.

<sup>507</sup> Barenfeld (27) 166.

<sup>508</sup> Barenfeld (27) 167.

<sup>509</sup> Barenfeld (27) 167.

entity forms.<sup>510</sup> Furthermore, it regards itself not as source country, but as residence state of the partnership.<sup>511</sup> There is therefore no justification or basis for forcing the partnership country to consider the partner country's classification in these situations.

The inapplicability of the above principle to these constellations was also recognized by the OECD itself.<sup>512</sup> According to the CFA a country should never be deprived of its right to classify and tax its own domestic entities, irrespective of the tax treatment in the other contracting country.<sup>513</sup> However, although the CFA regards its approach as a general principle that may be deviated from, its Partnership Report does nevertheless not provide for alternative solutions in this respect.<sup>514</sup> Therefore, by relying solely on the approach, advocated by the OECD, the present situation would remain unresolved, leading to a situation where different persons are entitled to the Convention benefits, namely the partnership itself according to its home country's perspective and the partner according to the German view. Two different DTCs would consequently be applicable.<sup>515</sup>

Apart from the discovered failure of the OECD approach regarding such cross-border partnership situations, the approach might also fail in other cases<sup>516</sup> due to other reasons.

The OECD did not change the wording of the Treaty<sup>517</sup>, but only the OECD Commentary by incorporating the new approach developed and published in the OECD Partnership Report. With respect to tax treaties negotiated after the new version of the commentary these amendments may be assumed to be considered by the Contracting countries. Insofar the approach of the OECD might have an impact on the provisions or the interpretation of the individual tax treaties.

However, it remains questionable, whether the new commentary is also relevant for the interpretation of tax treaties concluded prior to its amendments. As discussed

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<sup>510</sup> OECD Partnership Report (note 1) para 131.

<sup>511</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 34 b.

<sup>512</sup> OECD Partnership Report (note 1) 47.

<sup>513</sup> OECD Partnership Report (note 1) 47.

<sup>514</sup> OECD Partnership Report (note 1) 47; Barenfeld (note 27) 169.

<sup>515</sup> Stephan Gündisch 'Analoge Abkommensanwendung zur Überwindung von Qualifikationskonflikten' (2005) 24 *IStR* 829 at 829.

<sup>516</sup> For instance, where source in one State and partner and partnership in the other State.

<sup>517</sup> For reasons see chapter B section IV 2..

earlier<sup>518</sup>, the OECD advocates an ambulatory approach, meaning that the amended version of the Commentary may influence the interpretation of treaties concluded before its amendments. However as found, this approach lacks any reasoning and cannot be based on the provisions of the VCLT. Besides, the ambulatory approach does not comply with fundamental constitutional principles. The amended commentary is therefore generally of no impact for treaties entered into before the amendments, which is of significance, considering the huge amount of treaties concluded prior to the incorporation of the approach. Moreover, the Report lacks any convincing reasoning and can therefore even in this respect not be taken into account for earlier DTCs.<sup>519</sup> This lack of reasoning obviously narrows the impact even on treaties concluded after the new commentary version.

Whether the German jurisdiction generally pursues a static or an ambulatory approach with regard to the OECD Commentary could not be determined with certainty.<sup>520</sup> The court decisions are rather inconsistent and the BFH never clearly stated its position. It remains accordingly unpredictable how the courts will deal with this issue in future. Considering these weaknesses the relevance of the OECD approach is rather moderate for the actual treaty practice of the countries.

This rather moderate effect is also pictured by the German tax treaty practice. The German finance administration follows the approach only to a limited extent.<sup>521</sup> The source state must basically consider the treatment of the partnership in the partnership state. The income attribution rules remain, however, a matter of German domestic law and are to be applied irrespective of the partnerships entitlement to Convention benefits. As a result such entitlement comes sometimes rather to nothing. In a recent decision the German BFH had to deal with a situation, similar to the present one.<sup>522</sup> A German individual was a limited partner of a limited partnership<sup>523</sup>,

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<sup>518</sup> See chapter B section IV 2..

<sup>519</sup> Michael Lang (note 47) 20.

<sup>520</sup> See chapter B section IV 3..

<sup>521</sup> BMF 13. 1. 1997, BStBl. I 1997, 97; BMF 28. 5. 1998, BStBl. I 1998, 557; BMF 24.12.1999, BStBl 1999 I 1076; BMF 19. 3. 2004, BStBl. I 2004, 411. Quoted and discussed in Thomas Sliwka and Sebastian Schmidt 'Offene Fragen zum Beschluss des BFH vom 4. 4. 2007 zur intransparenten Personengesellschaft im Ausland' (2007) *IStR* 694 at 695 footnote 22.

<sup>522</sup> BFH 'Progressionsvorbehalt bei abkommensrechtlich steuerfreien Einkünften einer KG tschechischen Rechts' (2007) *IStR* 516 at 516.

<sup>523</sup> Referred to as 'Komanditni Spolecnost'.

situated in the Czech Republic and treated as corporation therein. The German individual claimed insofar a consequent application of the non-transparency principle also for German DTC purposes. However, the BFH only referred to the similarity approach when classifying the foreign entity for German tax purposes. It treated the entity accordingly as transparent without consideration of the treatment in the foreign country.<sup>524</sup> The German jurisdiction therefore seems rather to ignore the approach advocated by the OECD.

The obvious failure of the OECD approach in the present example, however, may be avoided if one shapes the wording of the principle in a slightly different way. Apart from the OECD CFA, many German and international scholars tried to solve the issue of entitlement to Convention benefits in case of a qualification conflict. Scholars frequently followed the OECD approach after its publication.<sup>525</sup> However, some of their approaches appear slightly different compared to the exact wording of the OECD approach. At least according to their wording they focus only on the tax treatment in the partnership country, without referring to a source country as country following that tax treatment.<sup>526</sup> Such an approach was also advocated prior to the publication of the OECD's partnership Report.<sup>527</sup>

In short, priority is given to the tax treatment in the country where the partnership has its legal seat or its place of effective management.<sup>528</sup> This wording applied to the present circumstances, the partner country would have to consider the tax treatment in the partnership country, irrespective of whether it regards itself as source or resident country. The qualification conflict at hand could therefore be resolved in a reasonable way.<sup>529</sup>

Such an approach could also be justified by reference to the treaty text. It follows from the OECD MTC that a partnership is a resident and entitled to the tax treaty

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<sup>524</sup> BFH (note 522) at 516.

<sup>525</sup> Frotscher (note 4) 179; Levedag (note 326); Müller and Wangler (note 250) at 147; Jacobs (note 164) chapter 4 A.I.2.b)(2).

<sup>526</sup> Müller and Wangler (note 250) at 147; Jacobs (note 164) part 4 chapter 4 A. I.2.b)(2); Frotscher (note 4) 179; Daniels (note 127) 169.

<sup>527</sup> Daniels (note 127) 169.

<sup>528</sup> Müller and Wangler (note 250) 147; Jacobs (note 164) part 4 chapter 4 A. I.2.b)(2); Frotscher (note 4) 179; Daniels (note 127) 169.

<sup>529</sup> Barenfeld (note 27) 168-169.

benefits, if it is treated as non-transparent and liable to unlimited taxation in its home country.<sup>530</sup> Since a DTC is a bilateral contract, binding both contracting states,<sup>531</sup> the entitlement to the provisions of the Convention must apply in relation to both States and should not be assessed differently.<sup>532</sup>

Whether or not the deviation from the wording of the OECD approach was intentional, the alternative approach, giving priority to the tax treatment in the partnership country constitutes at least according to its wording the more effective one, as it covers also cases where the OECD approach fails.<sup>533</sup>

However, even when applying this alternative approach, it remains the risk that the partnership country does not even apply the tax treaty considering the specific circumstances of the example at hand.<sup>534</sup> The partnership country regards its partnership as resident taxpayer. The profits are attributable to a domestic permanent establishment (source) and considered as derived by the domestic partnership. Even if the partner country follows the partnership's tax treatment in its home country, as suggested by the alternative approach, that country would regarding the partnership's profits perhaps not even see the necessity to apply the treaty entered into with the partner country<sup>535</sup>, as it still attributes the domestically earned income to its domestic partnership<sup>536</sup>. From its perspective, the taxation of the profits constitutes therefore a domestic matter only.<sup>537</sup>

From the partner country's perspective, on the other hand, the partner derives income from a foreign permanent establishment (source). The taxation therefore generally constitutes an international event<sup>538</sup>, leading to the application of the tax treaty between the concerned countries. However questionable is, whether the partner country would in fact still be willing to apply the tax treaty, when the partnership

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<sup>530</sup> See art 3 (1), 4 (1) OECD MTC; Frotscher (note 4) 179; Müller and Wangler (note 250) 147.

<sup>531</sup> Frotscher (note 4) 179.

<sup>532</sup> Frotscher (note 4) 179.

<sup>533</sup> Barenfeld (note 27) 168 and 169.

<sup>534</sup> Gündisch (note 515) at 831.

<sup>535</sup> This does not apply to the distributed profits. The distribution of profits to a foreign member constitutes no longer an entirely domestic matter. See Gündisch (note 515) footnote 14.

<sup>536</sup> Attribution rules are not covered by the treaty. See in this study chapter D section II 1.b)aa)(2)(2.1).

<sup>537</sup> Barenfeld (note 27) 374.

<sup>538</sup> Concerning two countries, the residence and the source country.

country is not.<sup>539</sup> If ultimately neither of the countries applies the tax treaty under these circumstances the income could be subject to unrelieved double taxation. Insofar both, the OECD approach and the suggested alternative approach fail as they only focus on solving the qualification conflict as such and do not address the specific tax situation in the partnership country under the present circumstances.

In order to deal appropriately with this issue Gündisch recently came up with a new approach.<sup>540</sup> He argues that the wording of the treaty does in fact not cover these qualification conflicts where two states due to their different tax classification of the partnership, attribute income to different persons. The OECD MTC's tax provisions are based on double tax relief between a source and a resident country and can accordingly not apply if there is a 'dispute over the question of which is the source state and which is the residence state' and where both countries are of the view to be the residence country. By the same token its provisions do not cover situations where one country is dealing with an entirely domestic matter actually not obliged to apply a tax treaty.

Considering that a tax treaty aims at relieving income from double taxation Gündisch argues that these situations should have been subject to treaty regulation and therefore nevertheless applies a treaty in these cases by analogy.

When applying the treaty analogously to the discussed qualification conflict the tax treaty interpretation shall in each country comply with their respective internal tax regime.<sup>541</sup> Moreover the analogous interpretation should conform to the direct application of the tax treaty to the greatest extent possible.

Applied to the present 'Outbound' investment<sup>542</sup>, the residence country of the partner must apply the treaty according to its internal tax regime. The partner country may therefore tax the income as residence country, but must equally grant double tax relief according to Art 23. The partnership state, as seen above, does not apply the tax treaty according to its internal tax regime.<sup>543</sup> As a result, the partner would

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<sup>539</sup> Gündisch (note 321) at 427.

<sup>540</sup> Gündisch (note 515) at 829.

<sup>541</sup> Gündisch (note 321) at 428.

<sup>542</sup> The Outbound situation discussed in this study corresponds to the example analyzed in the Gündisch articles.

<sup>543</sup> Gündisch (note 321) at 429.

however be relieved from double taxation on the income and the purpose of the tax treaty would accordingly be served.

Insofar the analogous application overcomes the issue, indicated above. It is however not very likely, that countries will adopt this way of interpretation in practice, as it has not yet gained much recognition and is accordingly rather unknown to the countries.

In conclusion, the wording of the approach advocated by the OECD does not apply to examples like the one at hand, where both countries are resident countries from their own perspective. As such cross-border partnership constellations occur frequently the approach might fail often in practice and might thus lose effectiveness in this respect.<sup>544</sup> The approach may also fail in other cases, as the amended commentary lacks relevance for the interpretation of older DTCs and is not appropriately reasoned. The issue of application to the present facts could be avoided by amending the wording of the approach and giving priority only to the tax treatment in the partnership country. However, from the partnership country's perspective the taxation of the profits constitutes a domestic matter only. It may therefore refuse the application of the tax treaty, leading to undesired double taxation. According to Gündisch this could be avoided by applying the treaty in such cases analogously. As this approach lacks recognition by the countries' treaty practice the issue might however remain.

In short, there is a real risk that the qualification conflict remains unresolved and that the tax treaty therefore does not apply.<sup>545</sup>

## **(2) Taxation of the profits**

### **(2.1) retained profits<sup>546</sup>**

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<sup>544</sup> Barenfeld (note 27) 168.

<sup>545</sup> The following however assumes that the tax treaty between the states applies.

<sup>546</sup> In case of a corporation the profits are regarded as retained as long as they are not yet distributed to its members. These profits are generally taxed at the level of the corporation. As soon as the profits are distributed the taxation concerns the member receiving the distributions. Since the partnership country treats its domestic partnership as corporation it has to be distinguished between retained profits taxed at the level of the partnership when earned and distributed profits taxed in the hands of the partner upon distribution.



According to the foreign country's tax law, the partnership is treated as a non-transparent corporation. The partnership is therefore subject to some sort of corporate tax on its profits when earned.<sup>547</sup> The income is taxed according to Art 7<sup>548</sup>, which leaves the right to tax with the state where the enterprise is situated, unless the profits are attributable to a permanent establishment in the other state. Treated as non-transparent corporation, the partnership constitutes the partnership country's enterprise in terms of Art 7 (1). The income of that enterprise is not attributable to a permanent establishment in Germany. The partnership country has therefore the right to tax the retained profits of its enterprise.<sup>549</sup>

## **(2.2) distributed profits<sup>550</sup>**

As the partnership is treated as non-transparent corporation the double-tax pattern applies. Profits distributed to the German partner are accordingly regarded as dividends in terms of art 10 (3) and subject to withholding tax upon their distribution.<sup>551</sup> The withholding tax is insofar reduced according to art 10 (2).

Therefore the profits are first subject to corporate tax at the level of the partnership and then subject to withholding tax upon distribution.

## **bb) Taxation in Germany as partner country**

### **(1) Entitlement to the Convention benefits**

As indicated above the partnership is treated differently in both contracting states. According to the OECD approach it is likely that this qualification conflict remains in the constellation at hand. Only by applying an alternative approach, where priority is given to the partnership state's tax treatment, the conflict is avoidable. Following such an approach Germany recognizes the partnership's tax treatment in the foreign state and respects its entitlement for tax treaty purposes. For the other reasons

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<sup>547</sup> See in this study chapter B section IV; Levedag (note 326) margin number 516; Jacobs (note 164) part 4 chapter 4 B.I.2.b). The partnership is insofar subject to unlimited taxation on its worldwide income.

<sup>548</sup> Frotscher (note 4) 182; Müller and Wangler (note 250) at 150.

<sup>549</sup> Müller and Wangler (note 250) at 150.

<sup>550</sup> See footnote 516.

<sup>551</sup> See art 7 (2) OECD MTC; see also Jacobs (note 164) part 4 chapter 4 B.II.2.(1)(b); Gummert and Weipert (note 326) margin number 516; Frotscher (note 4) 182; Müller and Wangler (note 250) 151.

indicated above it is however possible that the tax treaty between the countries does not even apply. This could only be addressed by applying the treaty by analogy, as advocated by Gündisch.

## **(2) Taxation of the profits**

### **(2.1) Retained profits<sup>552</sup>**

Under the circumstances of the present cross-border partnership constellation the tax treatment of these profits is subject to debate. In this respect German as well as international scholars come to completely different results.<sup>553</sup> To be distinguished are mainly two different ways of treating the profits for DTC purposes.

Some scholars are of the opinion that the profits are only subject to tax in the partnership country.<sup>554</sup> According to Art 7 the business profits are only taxable in the State where the enterprise earning the income is organized. From the perspective of the partnership country the partnership constitutes the enterprise contemplated in Art 7. It has accordingly been conferred the exclusive right to tax the partnership's profits. The partner country, on the other hand, has to exempt the profits from tax by accepting the 'per se exemption' in terms of Art 7. The fact that the countries treat the partnership differently shall insofar not be of any relevance.<sup>555</sup>

The provided exception to the 'per se exemption' leads here not to a different result, since the profits are not attributable to a permanent establishment in Germany.<sup>556</sup> A taxing right in the partner country is accordingly only imaginable upon distribution of the profits to the partner.<sup>557</sup> By leaving the partnership country the exclusive right

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<sup>552</sup> Germany generally treats the partnership as fiscally transparent. In its view the profits of the partnership are fully taxed in the hands of the partner when earned, irrespective of any subsequent profit distribution. From its perspective it has therefore basically not be distinguished between retained and distributed profits. However, in order to illustrate how the partnership's different tax treatment in the foreign country affects the tax treaty application in Germany, the classification of profits in retained and distributed profits is also applied with respect to the taxation in the German partner country.

<sup>553</sup> For an overview see Gündisch (note 515) Footnote 20.

<sup>554</sup> Jacobs (note 164) part 4 chapter 4 B.II.2.b); Müller and Wangler (note 250) 150-151; Barenfeld (note 27) 188; Daniels (note 127) 164.

<sup>555</sup> Barenfeld (note 27) 188.

<sup>556</sup> See Art 7 OECD MTC.

<sup>557</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 34 b; Jacobs (note 164) part 4 chapter 4 B.II.2.b).

to tax, double taxation of the retained profits is avoided without any need to apply Art 23 A or B.

Other scholars, however, apply Art 7 in a different way and leave the partner country the right to tax the profits.<sup>558</sup> From the perspective of the partner country the profits are considered to be the profits of the partner and not the partnership.<sup>559</sup> Accordingly the partner constitutes the enterprise for tax treaty purposes, whose profits are attributable to a permanent establishment situated in the partnership country.<sup>560</sup> As both States are allowed to tax the profits, double taxation occurs. The partner country feels accordingly obliged to exempt the profits from tax according to Art 23 A.<sup>561</sup> Alternatively, the partner country could grant a credit for foreign taxes.<sup>562</sup>

The BFH dealt with both opinions in its most recent decision about qualification conflicts.<sup>563</sup> It did, however, not follow either of the approaches taken. Although the opinions are different on their merits, the results are the same, at least if the latter approach leads to the application of the exemption method. Either double taxation is avoided by the 'per se exemption' in terms of Art 7 or by the application of the exemption method according to Art 23 A.

The 'per se exemption', however, basically assumes that the partner state follows the tax treatment as well as the attribution of profit rules applied in the partnership country.<sup>564</sup>

In principle, if the source country shall follow the tax treatment of the partnership in its country of organization, as advocated by the OECD or the alternative approach, it would be desirable if the income attribution rules of that country would equally be applied in the source country.<sup>565</sup> If the source country is free to apply its own income attribution rules, its consideration of the partnership's entitlement to treaty benefits in

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<sup>558</sup> Frotscher (note 4) 182.

<sup>559</sup> Frotscher (note 4) 182.

<sup>560</sup> See chapter D section II 1.a) aa)(2).

<sup>561</sup> Frotscher (note 4) 182.

<sup>562</sup> Some treaties are not based on the exemption method, but on the credit method.

<sup>563</sup> BFH (note 522) at 516.

<sup>564</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 34 b; Jacobs (note 164) part 4 chapter 4 B.II.2.b); Müller and Wangler (note 250) 150-151; Daniels (note 127) 165.

<sup>565</sup> See Jacobs (note 164) part 4 chapter 4 B.II.2.b); Daniels (note 127) 169.

the partnership country might be without effect for the actual application of the treaty provisions, as the qualification conflict insofar remains.<sup>566</sup>

Despite these good arguments in favor of such treaty application, it must however be considered, that the OECD MTC only covers the elimination of double taxation and does not deal with the issue of the attribution of the profits.<sup>567</sup> This is rather a matter of domestic law and even if the partner state accepts the partnership's tax treatment and its entitlement to the Convention benefits in the partnership country for the purpose of the tax treaty application<sup>568</sup>, it may still attribute the profits to its domestic partner. Therefore it cannot be agreed with the first opinion which applies the 'per se exemption' to the present circumstances.

The partner country is according to its income attribution rules not prevented from taxing its partner as enterprise in terms of Art 7. It rather keeps the right to tax the profits derived by the partner and eliminates the then arising double taxation only subsequently by granting a tax exemption or a credit for foreign tax.

Even if one follows the opinion applying the 'per se exemption' in principle, it has to be considered that the initial facts of the example at hand are different to the facts normally underlying this concept. Applying the OECD approach it is not very likely that the partnership state follows the tax treatment in the partner state for Convention purposes. That is generally not to be expected from the partner state either, as it regards itself as resident country of the partner and not as source country.<sup>569</sup> To require the partner country to abandon its own tax treatment would even contradict the OECD concept, which requires the source state to follow the partnership's tax treatment in its home country.<sup>570</sup> Avoidable is such an effect only by adopting the alternative approach and giving priority to the partnership's tax treatment in its home country. It is therefore likely that the qualification conflict remains and that both countries apply the Treaty provisions according to their own ideas, which would unavoidably lead to a treaty application as advocated by the second opinion.

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<sup>566</sup> Jacobs (note 164) part 4 chapter 4 B.II.2.b); Daniels (note 127) 164.

<sup>567</sup> Frotscher (note 4) 180; Guglielmo (note 52) 9.2.2..

<sup>568</sup> Which is in this case not very likely when following the OECD approach.

<sup>569</sup> Barenfeld (note 27) 198.

<sup>570</sup> Barenfeld (note 27) 198.

According to this latter approach the income is usually subject to exemption in the partner state and therefore relieved from double taxation, basically irrespective of a qualification conflict between the countries.<sup>571</sup> Some countries' tax treaties are, however, not based on the exemption method, but on the credit method according to Art 23 B. Insofar the approach followed would result in the application of the credit method by the partner country. With regard to the application of the credit method to the present qualification conflicts another problem is dealt with in the commentary to the OECD MTC, which should however basically also apply to the application of the exemption method.<sup>572</sup>

According to Art 23 B the resident country shall grant a tax credit in favor of its resident taxpayer if his income is subject to double taxation. Insofar the commentary states, that Art 23 A and B deal with the issue of international juridical double taxation, to be distinguished from economic double taxation.<sup>573</sup> Juridical double taxation refers to a situation where the same taxpayer is subject to tax on the same income.<sup>574</sup> Economic double taxation, however, involves two different persons taxable on the same income.<sup>575</sup>

In the present situation the partner country regards its resident partner as the taxpayer and consequently taxes the income in his hands. The partnership country, on the other hand, confers the tax liability on the partnership and taxes the income accordingly at its level. The qualification conflict therefore results in a situation where 'both States impose tax upon the same income, but on different taxpayers'<sup>576</sup>. This situation does not comply with the concept of international juridical double taxation. The partner state might accordingly not be willing to grant a credit for the taxes paid by another person, not regarded as the taxpayer in its view.<sup>577</sup> For the same reasons the application of the exemption method could be refused by the partner country, considering that the partner is actually not subject to tax in the

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<sup>571</sup> Frotscher (note 4) 182-183; Barenfeld (note 27) 214-215.

<sup>572</sup> Art 23 B para. 69.1-2 of the Commentary on the OECD MTC; OECD Partnership Report (note 1) para. 139.

<sup>573</sup> Art 23 para. 1 and 2 of the Commentray on the OECD MTC.

<sup>574</sup> Art 23 para. 3 of the Commentray on the OECD MTC.

<sup>575</sup> Art 23 para. 2 of the Commentray on the OECD MTC.

<sup>576</sup> OECD Partnership Report (note 1) para. 139.

<sup>577</sup> Barenfeld (note 27) 198.

foreign country, but the partnership. The taxation in the present example rather corresponds to the concept of economic double taxation, generally not addressed by the scope of Art 23.

With respect to the credit method the commentary states however elsewhere that the partner country should nevertheless be obliged to grant a tax credit for the tax paid by the partnership in the partnership country.<sup>578</sup> If the partner country ignores the partnership's tax treatment in its home country for the purpose of taxing the partners share in the profits it should equally ignore that treatment for the purpose of applying the credit method.<sup>579</sup> It should therefore 'flow through the tax paid by the partnership for purposes of eliminating double taxation arising from its taxation of the partners'.<sup>580</sup>

Despite its desirable results this latter statement appears rather contradictory, considering that the Commentary expressly requires the occurrence of juridical double taxation for the application of art 23.<sup>581</sup> For making an exception in this respect the approach lacks convincing reasoning and may therefore be only of minor relevance for the interpretation of double tax treaties.<sup>582</sup> As regards treaties, concluded prior to the amended commentary, the above applies.<sup>583</sup> Countries might therefore not be willing to follow the approach contemplated in the commentary.<sup>584</sup>

Some scholars seem to follow the OECD in this respect or advocate a similar approach.<sup>585</sup> There is however no case law on that issue. As regards the German tax treaty practice, it remains therefore uncertain, whether the partner state is obliged to allow for relief under such circumstances.<sup>586</sup>

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<sup>578</sup> Art 23 para 69.2 of the Commentary on the OECD MTC.

<sup>579</sup> Art 23 para 69.2 of the Commentary on the OECD MTC; see also OECD Partnership Report (note 1) para. 139.

<sup>580</sup> Art 23 para 69.2 of the Commentary on the OECD MTC; see also OECD Partnership Report (note 1) para. 139.

<sup>581</sup> Barenfeld (note 27) 197.

<sup>582</sup> Barenfeld (note 27) 198.

<sup>583</sup> See chapter B section IV 2..

<sup>584</sup> Barenfeld (note 27) 198.

<sup>585</sup> Frotscher (note 4) 184; Daniels (note 127) 185; Michael Lang, Markus Reich, Christian Schmidt 'Personengesellschaften im Verhältnis Deutschland – Österreich-Schweiz' (2007) 1 *ISrR* 1 at 7.

However, of other opinion is insofar Michael Lang.

<sup>586</sup> The BFH usually applies the exemption method in these situations. See BFH (note 522) at 516; Sliwka and Schmidt (note 521) at 694.

In principle, the concept of juridical double taxation should not serve as reason to refuse double tax relief in the present situation.<sup>587</sup> Insofar the commentary's approach can be agreed with. That the concept juridical double taxation is not complied with is only due to the qualification conflict arising between the countries. Fact is that the income is subject to double taxation, even if in the hands of different taxpayers. In order to serve the object of tax treaties, ie to eliminate double taxation, the particularities of qualification conflicts should be considered and double tax relief be granted, irrespective of whether the double taxation exactly corresponds to the concept of juridical double taxation. However as indicated, the legal situation is unclear and the reasoning of the OECD in its Commentary not convincing. The present situation therefore bears the risk of being exposed to final double taxation.

## **(2.2) Distributed profits**

The foreign partnership country applies Art 10 and subjects the distributions to a reduced withholding tax, as indicated above. The taxing right regarding the dividends is according to Art 10 basically also conferred to the German partner country.<sup>588</sup> However, according to the German domestic law the foreign partnership is considered transparent for tax purposes and following the single tax pattern the profits are directly and fully taxed upon earning in the hands of the partner. Later distributions by the partnership are non taxable and `merely seen as a transfer of previously taxed income<sup>589</sup>.<sup>590</sup> Germany has accordingly a right to tax the dividends according to the OECD MTC, but it has no domestic rule allowing for the taxation of the distributed profits.<sup>591</sup> The distributed profits are therefore taxed only in the partnership country.

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<sup>587</sup> Barenfeld (note 27) 196.

<sup>588</sup> See Art 10 (1) OECD MTC.

<sup>589</sup> Barenfeld (note 27) 199.

<sup>590</sup> Frotscher (note 4) 184; Müller and Wangler (note 250) 151.

<sup>591</sup> It has insofar to be recalled, that the tax treaty is not able to establish taxing rights or allocate those rights to the Contracting countries. The determination of the taxability of the income takes place under the domestic law of the contracting countries and the DTC may only apply subsequently to distribute or restrict the rights to tax already established and claimed by each country under their domestic tax law.

However, the question arises, whether Germany is nevertheless obliged to grant a credit for the tax levied on the distribution in the partnership state against its taxation on the retained profits upon earning.<sup>592</sup>

Provided the partner country exempted the retained profits either according to the 'per se exemption' or the exemption method<sup>593</sup>, double taxation does not arise.<sup>594</sup> As the partner state does not tax the distributions either, there is in these cases simply no taxation against which to credit the tax levied upon distribution in the partnership state.<sup>595</sup> The creditable amount then amounts to zero.<sup>596</sup> The profits are accordingly be taxed only in the partnership country according to the double tax pattern, subject to corporate tax at the level of the partnership and subject to reduced withholding tax upon distribution. A tax credit is insofar out of the question.<sup>597</sup>

However, where the partner country applies the credit method<sup>598</sup> regarding to the retained profits the situation is different. In the partner country the profits are subject to full taxation upon earning according to the single tax pattern. The partnership country subjects the profits to corporate tax upon earning at the level of the partnership and levies also withholding tax upon the distribution of the profits at the level of the foreign partner. Both, the single tax pattern applied in the partner country and the double tax pattern applied in the partnership country concern accordingly the same profits.<sup>599</sup> Provided the partner country grants a 'credit for the tax levied in the partnership country on the partnership against its own tax levied in the hands of the partner', the profits are only partly relieved from double taxation, as the credit only considers the taxation of the partnership's retained profits and not the taxation of the dividends in the partnership country.<sup>600</sup> In order to fully relief the double taxation in these situations, the single taxation of the profits in the partner country should be

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<sup>592</sup> Gummert and Weipert (note 326) margin number 516; Barenfeld (note 27) 199. In case of the double taxation of dividends usually the credit method applies.

<sup>593</sup> As indicated there are however issues with regard to application of these methods under the present facts.

<sup>594</sup> Frotscher (note 4) 183; Barenfeld (note 27) 214-215.

<sup>595</sup> Art 23 para 69.3 of the Commentary on the OECD MTC; OECD Partnership Report (note 1) para. 136; Frotscher (note 4) 183; Müller and Wangler (note 250) 151.

<sup>596</sup> Frotscher (note 4) 183.

<sup>597</sup> Frotscher (note 4) 182; BFH (note 522) at 516.

<sup>598</sup> As indicated there is however a problem with regard to the application of this method under the present facts.

<sup>599</sup> Barenfeld (note 27) 200.

<sup>600</sup> Barenfeld (note 27) 205.



relieved not only against the taxation of the profits at the level of the partnership (first part of the double tax pattern), but also against the taxation of the dividends in the hands of the partner (second part of the double tax pattern).<sup>601</sup> Otherwise double taxation arises.

It is therefore of particular relevance whether the partner state is obliged to grant a credit also regarding the dividend taxation in the partnership country.

According to some scholars this question is to be answered in the affirmative.<sup>602</sup> Although the distribution as such is not subject to tax in the partner country, the latter has to consider that it nevertheless taxed the profits of the partnership which in fact constitute the amount distributed.<sup>603</sup> Practical difficulties may, however, arise when the withholding tax on the distribution in the partnership country and the tax on the profits in the partner country are not levied in the same year of assessment.<sup>604</sup> In principle, one may nevertheless also in these cases argue, that the withholding tax merely constitutes the additional tax on previously realized and taxed profits.<sup>605</sup>

Others, however, refuse a credit obligation of the partner state.<sup>606</sup> As the partner state has no right to tax the dividends at the time of the distribution, it cannot be obliged to grant a credit in this respect.<sup>607</sup> As regards the German DTC practice the credit is particularly rejected if there is a timing mismatch, ie if the tax on retained profits in the partner country and the tax on the distributions are not levied in the same year of assessment.<sup>608</sup> This is also confirmed by the commentary to the OECD MTC, which clearly distinguishes between the generation of profits and their distribution.<sup>609</sup> It consequently states that 'the State of residence should not be expected to credit the

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<sup>601</sup> Barenfeld (note 27) 200.

<sup>602</sup> Frotscher (note 4) 184; Vogel (note 16) OECD-MA Artikel 1 margin number 34 b; Sliwka and Schmidt (note 521) at 695.

<sup>603</sup> Frotscher (note 4) 184.

<sup>604</sup> Frotscher (note 4) 184.

<sup>605</sup> Aigner/Züger, SWI, 2000, 254. Quoted and discussed in Sliwka and Schmidt (note 521) at 695.

<sup>606</sup> Jacobs (note 164) part 4 chapter 4 B.II.2.b); Müller and Wangler (note 250) 151.

<sup>607</sup> Müller and Wangler (note 250) 151.

<sup>608</sup> BFH (note 522) at 516; Sliwka and Schmidt (note 521) at 695.

<sup>609</sup> Art 23 para. 69.3 of the Commentaries on the OECD MTC; OECD Partnership Report (note 2) para. 137.

tax levied by the State of source upon the distribution against its own tax levied upon generation.<sup>610</sup>

Following the latter approach, the partner country would not be obliged to grant a credit for the tax levied on the distribution in the partnership country against its own tax levied on the profits. As indicated above, this would result in unrelieved double taxation.

The first approach seems however insofar reasonable as it considers that the partner country taxed the profits which are in form of distributions by the partnership to the domestic partner subject to further withholding tax in the partnership country.<sup>611</sup> The same profits are therefore subject to a more burdensome taxation than actually intended by the country's domestic tax systems.

As indicated, the OECD Commentary does not follow this reasoning. Although it requires the partner state to give a credit regarding the profits taxed in the partnership state upon earning<sup>612</sup>, this is according to the commentary not required regarding the distributions. However, if the partner country should ignore the tax treatment of the retained profits in the partnership country for the purpose of relieving double taxation in this respect, it should equally do so regarding the distribution<sup>613</sup>, as it is in fact the same income on which tax is levied.<sup>614</sup> Therefore, as the generated and the distributed profits concern the same income, the above distinction made by the commentary makes in fact little sense.<sup>615</sup>

In principle and apart from arising practical disadvantages<sup>616</sup>, the partner country should accordingly be required to grant the credit for the tax levied on the distribution in the partnership country, irrespective of its own treatment of these distributions for tax purposes. This would also serve the object of the tax treaty, namely to eliminate double taxation. However, the opinions are deeply divided on

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<sup>610</sup> Art 23 para. 69.3 of the Commentaries on the OECD MTC; OECD Partnership Report (note 2) para. 137.

<sup>611</sup> See Frotscher (note 4) 184; Sliwka and Schmidt (note 521) 695.

<sup>612</sup> See chapter D section II 1.b)aa)(2)(2.1).

<sup>613</sup> Also that it may be taxed in another year of assessment.

<sup>614</sup> See art 23 para. 69.2 of the Commentaries on the OECD MTC; Barenfeld (note 27) 204.

<sup>615</sup> Barenfeld (note 27) 204.

<sup>616</sup> The tax authorities would have to adjust the tax return, if the distribution is carried out in another year of assessment. See Barenfeld (note 27) 203.

this issue and the legal situation accordingly unclear. The risk of double taxation therefore remains.

## **2. German partnership/foreign partner (‘Inbound’)**

An individual is resident in a foreign country and derives as partner (P) income from a German partnership (PS). The German partnership carries on business through a domestic permanent establishment (PE).

### **a) Taxation if both countries apply the transparency approach**

#### **aa) Taxation in Germany as partnership country (source country<sup>617</sup>)**

##### **(1) Entitlement to the Convention benefits**

German partnerships are not entitled to the provisions of the OECD MTC, since they are regarded as fiscally transparent and therewith not liable to tax as such.<sup>618</sup> Instead the foreign partners are entitled to the Convention benefits provided they are resident in the foreign country and subject to unlimited taxation therein.<sup>619</sup>

##### **(2) Taxation of the profits**

When applying the OECD MTC to the income of foreign partners investing in a domestic partnership, Germany constitutes the source country. Insofar, the principle of permanent establishment applies according to Art 7.<sup>620</sup> The foreign partner's investment in a German partnership constitutes a foreign enterprise in terms of Art 7.<sup>621</sup> As the partnership is ignored for tax purposes its permanent establishment situated in Germany is directly attributable to the foreign partner. The foreign enterprise is accordingly to be regarded as carrying on business through a German permanent establishment. In Germany the partner is therefore subject to limited

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<sup>617</sup> Germany also constitutes the source country for the reason mentioned in footnote 430.

<sup>618</sup> See art 4 OECD MTC.

<sup>619</sup> See art 1, 3 (1) (a), 4 OECD MTC; analogous to the German provisions: s 1 (1) Income tax Act read with s 8, 9 Internal Fiscal Code.

<sup>620</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>621</sup> See discussion regarding a German partner.

taxation on his share of the profits attributable to the domestic permanent establishment.<sup>622</sup>

#### **bb) Taxation in the foreign partner country (residence country)**

##### **(1) Entitlement to Convention benefits**

The foreign country subjects its resident partner to unlimited taxation on his worldwide income. Accordingly the partner is entitled to the provisions of the OECD MTC.<sup>623</sup>

##### **(2) Taxation of the profits**

According to Art 7 (1) Germany is entitled to tax the foreign partner's distributive share of the domestic partnership's income. According to Art 7 the foreign partners are subject to unlimited taxation in the foreign country on the same share of the income.<sup>624</sup> The income is therefore subject to double taxation which needs to be avoided by the foreign country as the resident country.<sup>625</sup>

#### **b. Germany applies the transparency principle, the partnership is however regarded as non-transparent in the foreign country (qualification conflict)**

##### **aa) Taxation in Germany as partnership country**

##### **(1) Entitlement to Convention benefits**

At hand the countries treat the same partnership differently for tax purposes. Germany regards the partnership as fiscally transparent and the partner, resident in the foreign country, as liable to tax and entitled to the Convention benefits. However, the foreign country regards the German partnership as liable to tax as such and thus entitled to the provisions of the OECD MTC. Accordingly both countries take the

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<sup>622</sup> See art 7 (1), 3 (1) (c) OECD MTC; see also Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1); Rijkele (note 137) Germany-Partnerships 5.6.7.2..

<sup>623</sup> See Art 1, 3 (1) (a), 4 (1) OECD MTC.

<sup>624</sup> See art 7 (1) of the OECD MTC.

<sup>625</sup> See art 23 A or B OECD MTC.

view that the person liable to tax and entitled to the Convention benefits is a resident of the other country.<sup>626</sup>

According to the OECD approach the State of source shall consider and follow the partnership's treatment in the state where the persons claiming treaty benefits are resident. Provided the partner and the partnership are situated in Germany and the source in a foreign country, the approach would perfectly work. The foreign country would have to consider the transparency principle applied in Germany and to treat the partner as the person entitled to the Convention benefits.<sup>627</sup> As analyzed above, this does however not lead to a reasonable result when the source is situated in the partnership country and when accordingly both contracting countries constitute the residence state of either the partnership or the partner.<sup>628</sup> In the present example the source is again situated in the partnership country and both countries consider the resident of the other country as entitled to the Treaty benefits. Insofar neither the partnership country nor the country of the partner refers to the residence state. The OECD approach therefore again fails to apply on the basis of its wording.

From the perspective of Germany the qualification conflict is rather due to the fact that the foreign country ignores the tax classification of its domestic partnership when classifying the foreign entity.<sup>629</sup> In this situation, it is therefore not very likely that Germany, although source country<sup>630</sup>, recognizes the partnership's tax treatment in the foreign country by disregarding the tax classification of its own domestic entity.<sup>631</sup> It has to be considered that the partnership is not even entitled to the Convention benefits, as it is not a resident in the foreign country where it is considered as non-transparent entity.<sup>632</sup> The foreign partner country, on the other hand, cannot be regarded as the source country and is therefore according to the wording of the OECD approach not obliged to consider the tax treatment of the partnership in its home country. The qualification conflict might in this case

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<sup>626</sup> Barenfeld (note 27) 136.

<sup>627</sup> Frotscher (note 4) 185.

<sup>628</sup> See chapter D section II 1.b) aa)(1).

<sup>629</sup> Barenfeld (note 27) 167. Although the arguments referred to another example, they can equally be applied here.

<sup>630</sup> Jacobs (note 164) part 4 chapter 4 A. II..

<sup>631</sup> Barenfeld (note 27) 167.

<sup>632</sup> Frotscher (note 4) 181 and 185; Jacobs (note 164) part 4 chapter 4 A. II.; See also the requirements of Art 4 OECD MTC.

therefore remain. Neither the partner, as not resident in Germany in terms of Art 4, nor the partnership could claim tax treaty benefits with respect to the partnership's income.<sup>633</sup> By the same token neither of the contracting countries would provide for double tax relief.<sup>634</sup> The fact that the approach may fail under specific circumstances is recognized by the OECD with respect to the 'Outbound' situation discussed earlier.<sup>635</sup> Although not specifically dealt with in the OECD Partnership Report, this is also the case with the situation at hand.

This issue could only be resolved by following the alternative approach, which gives priority to the tax treatment of the partnership in its home country. Like in the 'Outbound' example discussed above, this approach does also apply to the situation at hand and would require the foreign partner country to follow the tax treatment of the partnership in Germany.<sup>636</sup> Accordingly the partners, resident in the foreign country, would be entitled to the Convention benefits for both contracting countries.

If the countries follow the approach advocated by the OECD the qualification conflict might remain under the present circumstances. This could only be avoided by giving priority to the tax treatment of the partnership in its home country.

## **(2) Taxation of the profits**

According to Art 7 (1) Germany is entitled to tax the foreign partner's share of the domestic partnership's income when earned.<sup>637</sup> The different tax treatment of the partnership in the foreign country is insofar of no impact.<sup>638</sup>

### **bb) Taxation in the foreign partner country**

#### **(1) Entitlement to the Convention benefits**

As set out above, the partners must be considered as being entitled to the treaty benefits by the foreign country. Otherwise, the conflict of qualification and its adverse effects remain.

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<sup>633</sup> OECD Partnership Report (note 1) 20-21.

<sup>634</sup> Barenfeld (note 27) 164.

<sup>635</sup> See OECD Partnership Report (note 1) para. 131.

<sup>636</sup> See also Vogel (note 16) OECD-MA Artikel 1 margin number 34 e.

<sup>637</sup> Barenfeld (note 27) 141-142.

<sup>638</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

## (2) Taxation of the distributed profits

As regards the taxation of the partner in the foreign country the distributed profits are of relevance only.<sup>639</sup> These profits are generally regarded as dividends from the foreign state's perspective.<sup>640</sup> Article 10 is however generally not applicable as the dividends cannot be regarded as being paid by a resident of the other contracting country.<sup>641</sup> Which distributive provision of the OECD MTC applies instead, is subject to debate among scholars.

Some scholars allocate the distributed profits to the business profits under Art 7.<sup>642</sup> According to Art 7 the country of the enterprise has the exclusive taxing right regarding the profits.<sup>643</sup> From the perspective of the foreign partner country this enterprise is situated in Germany. The profits are therefore to be exempted in the foreign country.<sup>644</sup>

Others<sup>645</sup>, however, consider the distributed profits as other income according to Art 21, which confers the exclusive taxing right in the present circumstances to the partner country.<sup>646</sup>

The problem with this approach is that it results in double taxation of the profits.<sup>647</sup> The partnership country taxes the income according to Art 7 fully upon earning based on the single-tax pattern. According to art 21 the partner country may tax the profits upon distribution according to the second part of the double-tax pattern.<sup>648</sup> As the income is already subject to full taxation upon earning, the tax upon distribution can be regarded as additional and beyond what is in fact intended under a single and double tax pattern.

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<sup>639</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1); Barenfeld (note 27) 142. As far as the perspective of the partner country is concerned, tax on the retained profits of the partnership, regarded as non-transparent, is levied when earned at the partnership's level in its home country, ie Germany.

<sup>640</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>641</sup> See Art 10 (1) OECD MTC; see also Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1); Vogel (note 16) OECD-MA Artikel 1 margin number 34 c. The partnership is not a resident in the partnership country, as it is considered as fiscally transparent.

<sup>642</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>643</sup> See Art 7 (1) OECD MTC.

<sup>644</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>645</sup> Vogel (note 16) OECD-MA Artikel 1 margin number 34 c.

<sup>646</sup> See Art 21 (1) OECD MTC.

<sup>647</sup> Jacobs (note 164) part 4 chapter 4 B.II.1.a)(1).

<sup>648</sup> According to the approach based on Art 21 OECD MTC.

However, situations like the one at hand merely refer to a direct investment which regularly leads to the application of either Art 7 or Art 10. Article 21 does therefore not apply. It has nevertheless to be considered that the German partnership country does not tax the distributed dividends. Therefore the partner country might not be willing to relief the income according to Art 7, as the dividends are from this perspective in fact not subject to double taxation as such.<sup>649</sup> That the same income is taxed in the partnership country as profits upon earning might insofar not be convincing, as the Commentary makes a clear distinction between generated profits and distributed dividends.<sup>650</sup> For the reasons above, however, this should not serve as a reason to refuse double tax relief. Due to legal uncertainty in this respect, the risk of double taxation nevertheless remains.

### **E. Alternative approach to the issue of qualification conflicts**

As seen in the previous parts, qualification conflicts lead to very complex issues with regard to the application of the OECD MTC and its double tax relief obligations. All approaches discussed regarding these issues aimed at resolving existing qualification conflicts in order to provide for the relief of double taxation. As found, when applying the different approaches to the examples above, the application of the tax treaty and the relief from double taxation remains in many instances nevertheless a matter of legal uncertainty.

Alternatively to these attempts, however, an approach could aim at avoiding a qualification conflict before its occurrence.

In order to avoid the occurrence of qualification conflicts with regard to cross-border partnerships one must address the origin of these conflicts.<sup>651</sup> A qualification conflict dealt with in this study refers to a situation where the same entity is treated as non-

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<sup>649</sup> Barenfeld (note 27) 216.

<sup>650</sup> Art 23 para. 69.3 of the Commentaries on the OECD MTC.

<sup>651</sup> See chapter C section VI.



transparent in one country and as transparent in the other country.<sup>652</sup> As discussed above, that may occur if two or more countries classify the same entity differently, as corporation or as partnership for tax purposes. That may also occur if countries treat partnerships generally as fiscally non-transparent. A conflict of qualification may then arise if the other country classifies the partnership as fiscally transparent, even if the entity is consistently classified as partnership by both countries.<sup>653</sup>

In short, a conflict of qualification occurs if either the same entity is classified<sup>654</sup> differently or treated differently for tax purposes in two or more countries.

In order to ensure consistent qualification of entities both of these causes must be addressed. To be clarified is insofar the main reason for the different tax classification or treatment of the same entity. Insofar the classification of entities for tax purposes shall serve as a point of departure.

Countries either classify their own domestic entities or foreign entities for domestic tax purposes. However, as found above and confirmed by the OECD a country has a 'sovereign right to create its own entities' and shall never be deprived of its right to classify and tax these domestic entities as it finds appropriate.<sup>655</sup> By the same token a country cannot be forced to re-characterize a domestic entity in order to resolve a qualification conflict with a foreign country which disregards the entity's characteristics in its home country and classifies it differently for tax purposes.<sup>656</sup> Therefore, when trying to avoid qualification conflicts one has to deal with the countries' classification and treatment of foreign, not domestic entities.<sup>657</sup>

Countries' apply different methods to classify foreign entities. As seen above, none of these methods is able to avoid qualification conflicts, but rather constitutes the main reason for this issue. This is mainly due to the fact that the foreign entity's classification and tax treatment in its home country is usually ignored when classifying the foreign entity for domestic tax purposes. The same entity may

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<sup>652</sup> Frotscher (note 4) 170; Barenfeld (note 27) 3. Also referred to as 'asymmetrical situation'.

<sup>653</sup> Frotscher (note 4) 170; Brincker (note 154) 552.

<sup>654</sup> Which results in a different treatment for tax purposes.

<sup>655</sup> Barenfeld (note 27) 256.

<sup>656</sup> Barenfeld (note 27) 168.

<sup>657</sup> Barenfeld (note 27) 256 and 257. The country, not constituting the country where the entity is organized, should accordingly provide for the consistent qualification of entities.

therefore be classified as non-transparent corporation subject to the double tax pattern in one country and as fiscally transparent partnership subject to the single tax pattern in the other country. Moreover, even if equally classified as partnership by both countries, the entity may be treated transparent in one country and non-transparent in the other country. Therefore, as partnerships constitute internationally a very heterogeneous entity form in terms of legal features and tax treatment it is very likely that partnerships are either classified differently as corporation or partnership<sup>658</sup> or treated differently for tax purposes. Therefore, since neither of the countries' classification methods considers the tax treatment of the entity in its country of organization they all give rise to qualification conflicts.

The non-consideration of the foreign partnership's tax treatment in its home country can therefore be regarded as the main reason for the different tax treatment of partnerships in the countries concerned.

The classification methods applied by the countries for the classification of foreign entities could therefore be utilized in a modified form in order to ensure a consistent qualification of entities by the contracting countries. It has to be determined however, which method is most qualified in this respect. As both, the fixed approach and the elective approach do not consider any characteristics of a foreign entity the similarity approach, at least taking into account the legal features of a foreign entity, seems to serve as the most appropriate point of departure for the creation of a method avoiding qualification conflicts.<sup>659</sup>

The similarity method can be summarized as referring to the legal features of a foreign entity, comparing them to the legal features of domestic entities and then applying the domestic tax treatment applicable to the entity most resembling the foreign entity under examination.<sup>660</sup> After considering the legal characteristics of the foreign entity, the classifying country applies domestic tax law, without the consideration of the entity's actual tax treatment in its home country.

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<sup>658</sup> Which in turn usually leads to a different treatment for tax purposes, as corporations and partnerships are usually subject to different tax patterns. See insofar chapter C section IV.

<sup>659</sup> Barenfeld (note 27) 258 - 263.

<sup>660</sup> Müller and Wangler (note 250) 146.

This may lead to considerable issues. As partnerships constitute very heterogeneous entity types the comparison of a foreign partnership with domestic entities can lead to an entity classified and treated as partnership in the foreign country and as corporation in the classifying country.<sup>661</sup> Besides, even if the classifying country's comparison to domestic entity types leads to a foreign entity classified as partnership in both countries, the classifying country only refers to its tax treatment of domestic partnerships and may therefore treat it differently in this respect as the partnership's home country does. The Similarity approach therefore bears the two reasons for qualification conflicts, ie the different classification and the different treatment of the same entity for tax purposes.

As suggested by Jesper Barenfeld, this may only be avoided by a so called 'tax – oriented' similarity approach<sup>662</sup>, ie a similarity approach only referring to the tax law characteristics of the foreign entity in its home country.<sup>663</sup> According to such an approach an entity treated as non-transparent in its country of organization would be treated in the other classifying country like its domestic entity types featuring the most resembling tax treatment, ie also as non-transparent according to the double-tax pattern.<sup>664</sup> By the same token an entity would be treated as transparent in both countries if it is treated that way in its home country.<sup>665</sup> The respective tax treatment would be applied by the countries irrespective of the entity's designation as partnership or corporation.<sup>666</sup> It would be the same regardless of where the entity's owner resides or where the entity's source is situated, as these classifying countries only take the tax treatment in the entity country into account.<sup>667</sup> Therefore, even if

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<sup>661</sup> Conversely, a foreign partnership may be regarded as corporation in the classifying country after comparison to domestic entity types.

<sup>662</sup> Analyzed by legal scholars as alternative approach. See insofar van Raad, Recognition of foreign entities as taxable entities (1988) 57, 58 and Avery Jones et al., Characterization of Other States' Partnerships for Income Tax (2002) 314, 315; quoted in Barenfeld (note 27) 262.

<sup>663</sup> Barenfeld (note 27) 261, 262.

<sup>664</sup> Usually country of owner or source.

<sup>665</sup> Barenfeld (note 27) 261.

<sup>666</sup> Insofar it has to be considered, that qualification conflicts refer to a situation where the same entity is treated differently for tax purposes. Its designation as partnership or corporation is insofar not decisive, as some countries treat partnerships like corporations for tax purposes.

<sup>667</sup> Barenfeld (note 27) 256-257.

the cross-border partnership structure involves more countries<sup>668</sup>, the tax oriented similarity approach would still lead to consistent qualification of the partnership.

As the approach normally leads to consistent qualification of the entity and therewith consistent application of the tax treaty, double taxation would be regularly relieved in cross-border partnership cases.<sup>669</sup>

In view of these positive effects, the adoption of such an approach should be considered with respect to the German tax practice. As Germany already applies a similarity approach for the classification of foreign entities, a tax oriented similarity approach would only require the further development of the existing system, rather than the introduction of a completely new classification regime.<sup>670</sup> Insofar the approach has potential.

The adoption of a tax oriented similarity approach in Germany might, however encounter resistance for other reasons.

If countries treat foreign entities based on their foreign tax characteristics, the entity may be treated differently than corresponding domestic entities.<sup>671</sup> Some German scholars therefore argue that the consideration of foreign tax characteristics may violate the principle of equality of taxation.<sup>672</sup> According to that constitutional principle, identical economic circumstances must be treated equally for tax purposes irrespective of whether realized domestically or abroad. Such concerns with respect to a tax oriented classification of foreign entities are also shared by other international scholars.<sup>673</sup> According to them the method may be discriminatory, as it may result in foreign entities being treated differently compared to domestic entities, although sharing similar or identical characteristics.

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<sup>668</sup> Where the partnership, situated in one country, has income sources and/or partners in more than one foreign country.

<sup>669</sup> See the cases under chapter D where both countries treat the same entity as transparent for tax purposes.

<sup>670</sup> Barenfeld (note 27) 261. For these reason the approach has also potential internationally, as many countries already apply the basic similarity approach.

<sup>671</sup> Barenfeld (note 27) 332-333.

<sup>672</sup> Müller and Wangler (note 250) 146.

<sup>673</sup> Van Raad, Recognition of foreign entities as taxable entities (1988) 57, 58. Quoted in Barenfeld (note 27) 262.

Questionable is, however, whether the approach would in fact lead to such discriminatory treatment. Insofar it is argued that discrimination cannot occur in case of a qualification conflict, as the entities are not placed in the same circumstances.<sup>674</sup> A foreign entity which corresponds to a domestic entity in all aspects, except for its tax characteristics, cannot be regarded as being placed in identical circumstances. If a foreign partnership is treated as non-transparent for tax purposes and domestic partnerships seen as fiscally transparent, the classification of the foreign entity as non-transparent does not discriminate between the domestic and the foreign partnership, as these partnerships are not placed in identical circumstances.<sup>675</sup> The different classification for tax purposes is insofar not discriminatory.

The argument that the entities must be placed in identical circumstances in order to be subject to a non-discrimination provision appears very reasonable. Discrimination, by definition, has to be determined on 'objects or subjects of the same kind and in the same circumstances'.<sup>676</sup> In context of a non-discrimination rule regarding the taxation of entities, the tax treatment of these entities constitutes the decisive factor to establish whether the entities are in the same circumstances and therewith comparable.<sup>677</sup> A foreign partnership treated as transparent is accordingly not in the same circumstances as a domestic partnership treated as non transparent. The concerns above are therefore not able to stop the tax oriented similarity approach.

Other problems might arise when applying the approach in practice. In order to recognize the tax treatment of foreign entities, the classifying country has to know about the entity's tax treatment in its home country. However, as discussed above, the normal similarity approach has to deal with different foreign general law characteristics of the entity in its home country and has to compare them with German entity types, featuring similar or identical characteristics. Compare to this complex process the tax oriented similarity approach leads rather to simplification, as it only focuses on one tax characteristic, ie whether the entity is treated as transparent or non-transparent. This is particularly advantageous concerning heterogeneous

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<sup>674</sup> Barenfeld (note 27) 334-343. This was analyzed with respect to art 24 OECD MTC. The results may however also be applied to other discriminatory provisions or principles.

<sup>675</sup> Barenfeld (note 27) 338 -340.

<sup>676</sup> Barenfeld (note 27) 341.

<sup>677</sup> Barenfeld (note 27) 342; see also Art 24 para. 3 Commentaries on the OECD MTC.

entity types, like partnerships. Furthermore, as relating to the normal similarity approach, the German tax administration could release guidelines or lists with foreign entity types in different countries in order to assist the authorities when applying the tax oriented similarity approach.<sup>678</sup> Insofar the list must only state the tax treatment of the foreign entities in their home countries.

Problems from an administrative perspective are therefore minor and can consequently not serve as a reason to object a tax oriented similarity approach.

However, the tax oriented similarity approach would only accomplish consistency in all matters, if it is adopted in the domestic tax law of a country.<sup>679</sup> As indicated above, a tax treaty does only cover the elimination of double taxation, but not the classification of the entity for domestic tax purposes and the attribution of its income. The adoption of the approach in a tax treaty would therefore only influence the determination of who is entitled to the Convention benefits.<sup>680</sup> The question of who the income is attributed to lies outside the scope of a tax treaty.<sup>681</sup> The above issues regarding the application of the tax treaties and its double tax relief rules would remain, as the domestic qualification conflict prevails.<sup>682</sup> The approach must therefore be in German domestic law.

With this in mind, the tax oriented similarity approach constitutes in principle a promising opportunity to solve the issue of qualification conflicts between countries at its roots. Although accompanied by legal amendments and administrative efforts it would regularly result in relief of double taxation regarding cross-border partnership situations and therewith provide for some tax certainty in this respect. Adopted by all countries the approach could even accomplish this on a worldwide basis.

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<sup>678</sup> Barenfeld (note 27) 262.

<sup>679</sup> Barenfeld (note 27) 352.

<sup>680</sup> Barenfeld (note 27) 352.

<sup>681</sup> See chapter D section II 1.b)bb)(2)(2.1).

<sup>682</sup> Barenfeld (note 27) 352.

## **F. Conclusion**

Due to its different tax treatment in different countries a partnership gives in a cross-border situation rise to many issues regarding the application of tax treaties. As seen in the discussed 'Outbound' and 'Inbound' examples the issues particularly concern the entitlement to the tax treaty benefits and the treaty's double tax relief provisions. In either case the qualification conflict may prevent the tax treaty from providing double tax relief.

The different approaches applied to the examples may insofar not serve as an appropriate solution of these issues. The OECD approach may apart from its other weaknesses basically solve the issue of qualification conflicts in other cross-border constellations. It does however not address the specific issues of the 'Outbound' and 'Inbound' situation discussed. Neither does the committee provide for any alternative suggestions in this respect. The risk of double taxation therefore remains and leaves these situations with legal uncertainty and unpredictability from the taxpayer's and tax administration's point of view.

This is deplorable, considering the following statement in the OECD MTC about the issue of double taxation:

'Its harmful effects on the exchange of goods and services and movements of capital, technology, and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.'

A 'tax oriented similarity approach' may serve as an appropriate attempt to ensure double tax relief also in situations like the Outbound and Inbound above. Qualification conflicts may arise in endless different cross-border partnership constellations, including triangular situations, and may insofar result in countless different issues regarding the application of tax treaties. Approaches aiming at solving these issues, like the ones discussed, therefore cannot address all imaginable cross-border constellations. The tax oriented similarity approach, however addresses the issue of qualification conflicts at its roots and thereby avoids their occurrence in the first place. According to that approach countries, when classifying foreign entities for domestic tax purposes, shall only refer to the foreign entity's tax treatment in its country of organization and shall treat the foreign entity for domestic tax purposes like its domestic entity types featuring the most resembling tax

treatment. A qualification conflict would therefore not arise as the entity is treated the same way in terms of taxation by all countries involved. Issues with regard to tax treaty application would not arise and double taxation regularly be avoided. As found there are no convincing reasons to refuse such an approach, especially in view of its potential with regard to cross-border partnership cases.

Unfortunately it has rather rarely been subject to analysis in legal writings<sup>683</sup>, which might be due to discrimination considerations and required radical amendments of countries' domestic tax systems not already applying the basic similarity approach for the classification of foreign entities.

However, its potential should be more recognized. The approach constitutes a way to address the issue of qualification conflicts on a very broad basis. As seen in this study the issue remains an uncertain area of law with deeply dividing opinions. There is so far no single convincing concept to deal with all the tax problems involved. The tax oriented similarity approach should therefore appear more frequently in academic writings and be subject to further analysis and development, considering the increasing importance of partnerships as instrument of international investments.

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<sup>683</sup> See Barenfeld (note 27) chapter 9; van Raad, Recognition of foreign entities as taxable entities (1988) 57, 58 and Avery Jones et al., Characterization of Other States' Partnerships for Income Tax (2002) 314, 315. Both quoted in Barenfeld (note 27) 262.



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